

# **China's Transition to a Market Economy:**

## **How Far across the River?**

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### Abstract

China's two-decade reform since 1979 has evolved in two stages with the November 1993 decision marking a turning point. The essence of this decision is to replace the planning system with a modern market system. We examine the process of change in the mind-set of the leadership and analyze its political, economic, and intellectual basis. We then evaluate the progresses made during the first five years (1994-98). To investigate the remaining challenges, we choose to focus on what we regard as the core issue: establishment of a free and competitive enterprise system by changing the government-business relationship to an arm's-length type. Three necessary tasks are: (i) transforming state-owned enterprises; (ii) promoting private enterprises; and (iii) establishing the rule of law. In each, we assess the current status and analyze the opportunities and difficulties for future development.

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"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way, ....."

-- Charles Dickens, *A Tale of Two Cities*

## **1. Introduction**

By the end of 1998, China's economic reform has gone through two full decades. China's transition from a planned to a market economy has often been portrayed as a gradual and experimental process, or in Deng Xiaoping's widely quoted phrase: "crossing the river by groping for stones." But how far has China progressed across the river? How tough is the remaining journey? And how will China navigate to the other side of the river? This paper will give some assessment of these important questions.

We view China's transition to markets as an evolutionary process in two stages, where the first stage spanned about fifteen years between 1978 and 1993 and the second stage began in 1994. Although the two stages had much continuity between them, the division is quite clear: the watershed being the historic decision of November 1993, "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure," adopted by the Third Plenum of the Fourteenth Congress of the Chinese Communist Party.

To better understand the significance of this decision, we need to first review the nature of the first stage reform, which is the topic of section 2. In that stage, while the basic institutional framework of central planning remained intact, the reform was carried out incrementally to improve incentives and to expand the scope of the market for resource allocation. The

incremental reform achieved most success outside the state sector rather than inside the state sector. It was actually a big success: it generated high growth, dramatically improved people's living standards, and eliminated shortage, the common symptom of all planned economies. Its significance can only be understood when compared with the seemingly similar reforms in Eastern Europe prior to 1990. The most remarkable example is Hungary, which pioneered a serious economic reform by abolishing mandatory planning targets for enterprises as early as in 1968 and became a role model for the Chinese reformers in the early 1980s. However, the Hungarian reform failed to eliminate shortage and the Hungarian economy stagnated in the 1980s (Kornai, 1986). Similar stories might be told for Poland and the Soviet Union. The failures of economic reform in Eastern Europe provided an impetus for a more radical approach to reform, which only became possible and put into practice after the fall of the Communist Parties from the power around 1990. Against this background, the Chinese success in its incremental reforms between 1978 and 1993 was a big surprise, and has pioneered an alternative way of transition from plan to markets.

The November 1993 decision is a historic document because it represents a strategic shift in the course of China's reform. For the first time and in essence, it decides to abolish the planning system altogether and set the goal of reform to be the establishment of a modern market system eventually to incorporate international institutions recognized as "best practice." This made the second stage of China's reform beginning 1994 comparable to that in Eastern Europe after 1990 and in the former Soviet Union countries after 1992, although the political and economic background leading to such reforms are quite different. As well known, in all countries of Eastern European and the former Soviet Union, transition to markets began after political

democratization. In contrast, China entered the transition stage without such a political reform. In section 3 we will examine the process of change in the mind-set of the leadership and its political, economic, and intellectual basis.

In the first five years since 1994, China attempted several radical reforms according to the November 1993 decision. The major ones include unification of exchange rates and convertibility under the current account; the overhaul of the tax and fiscal systems with the separation of national and local tax administrations; and reorganization of the central bank, including establishing cross-province (i.e., regional) central bank branches. China also started to privatize small-scale state-owned enterprises, to lay off excess state employees, and to establish a social safety net. In section 4 we will provide a critical evaluation of the progresses in these areas between 1994 and 1998.

Despite of the great achievement, China still has a long way to go on its progression toward the other side of the river -- a modern market economy. To investigate the remaining challenges, one is often tempted to prepare a long and comprehensive menu covering many issues and all of them seem important. But what is the core issue? In section 5, we argue that the core issue is the change of the government-business relationship to an arm's-length type with an establishment of a free and competitive enterprise system. This is a foundation of any modern market system. No one would deny the importance of tax reform, financial reform, or external sector reform, for example, but without this foundation no tax or financial system can function well. To fundamentally change government-business relationship, we consider three tasks necessary: (i) transforming state-owned enterprises (SOEs); (ii) promoting private enterprises; and (iii) establishing a rule of law to govern the government-business relationship. In each, we

describe the current status, analyze the opportunities and the difficulties, and examine possible development trends.

We conclude in section 6. To be sure, there is no precedent for a country under the rule of a Communist Party to make a successful transition to a fully-fledged market economy. Nor is there a precedent under which a centrally planned economy reformed successfully in an incremental way before China did it in its first fifteen years of reform. No existing theory would predict either success or failure in China's second stage of reform. China faces many difficult challenges, but it also has many opportunities. One new favorable factor is China's imminent accession to the World Trade Organization (WTO), which we argue will provide an important and timely impetus for its further and faster reform. We are cautiously optimistic for China to make a quantum leap in the next decade in its transition to a modern market economy.

## **2. The Nature of the Reform in the First Stage (1978-93)**

Compared to the dismal economic performance of the Eastern European reforms in the 1970s and 1980s, China's incremental reform between 1978 and 1993 was a remarkable success. During this period, China's GDP grew at an average annual rate of about 9 percent, or 7.5 percent on a per capita basis. The living standard of ordinary Chinese people improved significantly. For example, an average Chinese consumer increased his/her consumption about three times for edible vegetable oil, pork, and eggs. The per person living space has doubled in urban areas and more than doubled in rural areas, and total household bank deposits, measured against the GDP, increased from less than 6 percent in 1978 to more than 40 percent in 1993. The number of people living in absolute poverty was substantially reduced from over 250 million to less than 100

million in this period as well. By the end of 1993, reform was supported by people in all walks of life simply because almost everybody benefitted from it. This was in sharp contrast with the frustration of Eastern European reformers in the late 1980s, when they saw only a dead end to their reform efforts of decades (Kornai 1986, 1992).

Why was China able to avoid the failure of Eastern European reform? The answer is deeper institutional changes than those in Eastern Europe (Qian, 1999; Wu, 1999). These changes take the form of "incremental reform" (*zengliang gaige*), that is, introducing dramatic changes outside, rather than inside, the existing core of central planning. The most significant is the rapid rise of a sector outside the state sector, known as the "non-state sector" (Qian and Xu, 1993; Wu, 1999). In agriculture, nearly 100% activities have been organized by household farming by the early 1980s. In non-agriculture activities, the non-state sector includes a variety of ownership forms of enterprises, such as collectives, cooperatives, private businesses, joint ventures with foreign firms, and sole foreign invested firms. Unlike SOEs, non-state enterprises operated outside of the scope of central planning, and they were subject to harder budget constraints and faced more competition than SOEs. The non-state enterprises soon became the engine of growth and industrialization. In 1978, the share of the state sector in industrial output accounted for 78 percent of the national total; by 1993, it was down to only 43 percent. The share of the state sector in commerce was 55 percent in 1978, and it was down to 40 percent by 1993. Because of the absence of privatization of SOEs during this period, the changes of the relative weight of the non-state sector were entirely due to its very fast growth. In contrast, in Eastern European countries, despite decades of reform, in the late 1980s, the state sector continued to dominate the economy and their "second economy" (that is, the non-state sector)

remained insignificant, especially in industry (Kornai, 1986). However, it is worth noting that during this period foreign direct investment in China was not significant yet, accounting for less than 5 percent of total investment by the early 1990s. Furthermore, domestic private firms were not significant either, and most of non-state firms were actually local government controlled collective enterprises, such as rural Township-Village Enterprises (TVEs).

Accompanying the rise of the non-state sector was the development of markets. Price reform started in the way known as "dual-track" mechanism, that is, prices were free up at the margin while the planned prices were maintained for planned quantities freezed for some time (Wu and Zhao, 1987; Lau, Qian, and Roland, 2000). Again, this is a form of incremental reform. As a result, true domestic market prices for all goods were established quickly and as early as in the mid-1980s. The planned track was largely phased out in the early 1990s, and by 1993, more than 90 percent of prices (in terms of industrial output values) were determined by market forces rather than by the government. In contrast, in Hungary, despite the fact that mandatory planning targets were abolished as early as in 1968, most prices continued to be "administered" by bureaucrats and not determined by the market by the late 1980s (Kornai, 1986). China's market development was also pushed by its fast expansion of foreign trade. Due to the opening policy, both export and import increased much faster than GDP. For example, export to GDP ratio increased from less than 5% in 1978 to more than 20% by the early 1990s. The expansion of foreign market interacted with domestic market development, which helped push the convergence of the two tracks.

In essence, achievements up to 1993 were made through clever incremental reforms, which differed significantly from the Eastern European reforms up to 1989. On the other hand,

these reforms were often ad hoc responses to particular constraints of the planning system or took advantages of the loopholes in it. For example, "contracting" between different levels of government and between government and enterprises/households prevailed. Although such a contracting was effective in eroding central planning, these contracts were ad hoc and subject to frequent renegotiations and change. In the final analysis, by the early 1990s, the core of central planning remained.

Lenin, in his famous book *State and Revolution*, has characterized a centrally planned economy as a State Syndicate and a Party-State, Inc. Lenin's original description referred to the situation where the entire society becomes one factory and all the people becomes employees of the Party-State. In its narrow sense, this description does not apply even to pre-reform China (nor the former Soviet Union), because of the complex of internal organizational structure involving both state and collective sectors. But the essential point of Lenin's Party-State remained valid for both pre-reform and post-reform China. The Party-State is reflected in the following three areas. First, state-owned enterprises are still controlled by the State and the Party in an old fashion way, if not for daily operation, but certainly for strategic decisions. No single state enterprise was privatized and almost none went bankrupt. No state employees were ever laid off for economic reasons. The Party appoints top managers in state enterprises. Although the state sector shrank significantly in relative terms, it expanded in absolute terms in employment, output, and assets. Second, truly private enterprises did not develop at a healthy pace. Truly private enterprises accounted for less than 15 percent of industrial output by the end of 1993, and almost all of the domestic private enterprises had less than 8 employees. Most non-state enterprises, such as TVEs, were collective or joint ventures which were essentially local government



controlled and not truly private. Local government is, of course, part of the State. Third, new market-supporting institutions were not built to replace the old planning institutions. China did not have a market-supporting fiscal system, financial system, system of corporate governance, social security system, and a modern legal system, for example. Fundamentally, there was no rule of law, and the State and the Party, not laws, were governing the economy.

### **3. The Essence of the November 1993 Decision and Why the Change**

The November 1993 decision marks a watershed change, indicating the beginning of a new direction of economic reform. To understand the significance of this turning point, we start by discussing the main contents of this decision and several follow-up decisions. We then analyze the political and economic basis for the leadership to make such a strategic shift as well as the intellectual inputs contributing to the change.

#### *A. The Essence of the November 1993 Decision and Subsequent Ideological Changes*

At the outset of reform, China desired change in order to increase productivity and improve living standards, but at no time did the leadership think of introducing a full-fledged market system (Perkins, 1994). During the first fifteen years of reform, the official ideology was the one of "combining plan and market together."

In the early 1990s, the mind-set of the leadership started to change. In the spring of 1992, Deng Xiaoping made his famous Southern tour to mobilize local support for further and more radical reform. The big ideological breakthrough occurred afterwards at the Fourteenth Party Congress held in September 1992 when the Party, for the first time, endorsed the "socialist market

economy" as China's goal of reform. It is important to distinguish the Chinese "socialist market economy" from "market socialism" as advocated by some Eastern European reformers in the 1970s and 1980s. In market socialism, the market is a simulated one to serve the purpose of socialism based on public ownership (Kornai, 1992). In contrast, in a socialist market economy, the word "socialist" is an adjective and the goal is "market economy." Therefore, a socialist market economy differs from market socialism in a fundamental way.

The contents of transition to a socialist market economy became clearer one year later. In 1993, the Communist Party's Economics and Finance Leading Group, headed by Party Secretary General Jiang Zemin, worked together with economists to prepare a grand strategy of transition to a market system. Several research teams were formed to study various aspects of transition, ranging from taxation, the fiscal system, the financial system, and enterprises, to foreign trade. The final output was the "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure" adopted by the Third Plenum of the Fourteenth Party Congress in November 1993 (*China Daily*, November 17, 1993).

The essence of the November 1993 decision is to replace China's centrally planned system with a modern market system eventually to incorporate international institutions recognized as "best practice." This landmark document represented a turning point on China's road to a market economy. This document, together with several subsequent decisions, is a very significant historic event.

The decision made two major breakthroughs. First, the decision called for building of market-supporting institutions, such as formal fiscal federalism, a centralized monetary system, and a social safety net. For example, separation of central and local taxes and their administration

was a critical step in moving toward formal fiscal federalism. Revenue transfers between the central and provincial governments were to be based on a fixed formula rather than bargaining. It represents the beginning of a rule based system.

Second, the decision addressed the enterprise reform issue in a more fundamental way -- property rights and ownership. It decided to transform SOEs into "modern enterprises" with "clarified property rights, clearly defined responsibility and authority, separation of enterprises from the government, and scientific internal management." Also, for the first time, it left the door open regarding the privatization of SOEs: "As for the small state owned enterprises, the management of some can be contracted out or leased; others can be shifted to the partnership system in the form of stock sharing, or sold to collectives and individuals." But a further breakthrough on ownership issues had to wait a while.

In the November 1993 decision, state ownership was still regarded as a "principal component of the economy" while private ownership was a "supplementary component of the economy." The Fifteenth Party Congress held in September 1997 made a major breakthrough on ownership issues: State ownership was downgraded to a "pillar of the economy" and private ownership was elevated to an "important component of the economy." In Chinese politics, these subtle changes of rhetoric mean a big change in ideology. The document recognized that "varieties of ownership should develop together," but because private ownership was discriminated against for decades, the only new information here was that private ownership had gained legitimacy. Furthermore, although the rhetoric of public ownership was maintained, its meaning was redefined, because public ownership may have many "different realization forms," such as joint stock corporations with investment by several, rather than a single, owners.

The second major breakthrough of the Fifteenth Party Congress, which was somewhat overshadowed by the ownership issue but nevertheless more important, is its explicit emphasis on the rule of law. As always in China, the content of the rule of law will evolve over time. The rule of law is not the same as democracy. For example, the two most free market economies, Hong Kong and Singapore, have the rule of law but are not democracies by Western standards. Chinese leadership seemed to decide to give priority to the rule of law rather than democracy. It is not hard to understand: the rule of law is clearly crucial for a modern market economy, but not directly and immediately threaten the governing power of the Party.

Both private ownership and the rule of law were formally incorporated into the Chinese Constitution in March 1999.<sup>1</sup> An amendment of Article 11 of the Constitution places private businesses on an equal footing with the public sector by changing the original clause "the private economy is a supplement to public ownership" to "the non-public sector, including individual and private businesses, is an important component of the socialist market economy." Moreover, Article 5 of the Constitution was amended to include the principle of "governing the country according to law and establishing a socialist, rule of law country." These Constitutional amendments are a major step for China's transition toward a full market system based on the rule of law.

The failure of the pre-1990 Eastern European reform has led to persuasive arguments for the need of democratic reform to precede economic transition (Kornai, 1992). The Communist Parties there were unwilling to change their ideology. The collapse of the Communist Parties in

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<sup>1</sup> "Top lawmakers yesterday overwhelmingly endorsed China's landmark constitutional amendments which enshrine the 'rule of law' and bolster the status of private businesses" (*China Daily*, March 16, 1999).

Eastern Europe was the logical consequence. China provided a case that proved impossible in Eastern Europe and elsewhere: the Chinese Communist Party itself made the ideological shift voluntarily. As a result, China has become the first country where the ruling Communist Party has voluntarily changed its official ideology to embrace a market economy and private ownership. This raises a fundamental question: What brought about the change in the mind-set of the Chinese leadership? Below we attempt to answer this question from the political, economic, and intellectual perspectives.

### *B. The Political Will*

The primary political objective of the Party is maintaining its power. The political will of the leadership for economic reform is shaped by both domestic political events as well as geopolitics. It is based on the following central proposition: economic reform is good for economic development, which in turn is good for maintaining Party's power.

In this regard, we highlight the important legacy of the Cultural Revolution. The Cultural Revolution taught the Chinese leadership an important lesson that economic development is the key to maintaining its power. During the Cultural Revolution between 1966 and 1976, the central focus of the Party was "political movement," which resulted in disastrous consequences to the national economy and the living standard of the people. Lack of economic development fueled mass resentment to the Party, although officially such a resentment was targeted toward the "Gang of Four." The experience of the Cultural Revolution has enormous effects on the mind-set of some top leaders. They were convinced that without economic development the Party cannot survive, in other words, the necessary condition for maintaining Party's power and regaining

popular support is economic development. To a large extent, the displacement of the dogmatic ideology in favor of pragmatism was due to the backlash of the Cultural Revolution. The proposition of economic development became even more compelling after the 1989 Tiananmen Square incident, because it was the only source from which the government to gain its legitimacy. In Deng Xiaoping's own words, "[economic] development is the hard rule."

After the Cultural Revolution, reverting to the Soviet type central planning was out of question because such a system never prevailed in China since 1958. The only debate was on the scope of market relative to central planning and the extent of opening. The information arriving from the Chinese neighbors provided strong evidence in favor of increasing the role of market and opening. Most Chinese were stunned by the fast economic development of Japan and the "Four Little Tigers" of Hong Kong, Taiwan, Singapore and South Korea during the time period of the Cultural Revolution. Referring to the success of Hong Kong, Deng Xiaoping reportedly said that, although he does not have a good knowledge about economics, he can tell it is a good economy when he sees it.

The commitment to economic development for the purpose of maintaining power has enormous impacts on the course of economic reform. When the Party felt deepening reforms necessary to sustain economic growth, it pushed for more reforms. The start of economic reform in 1979 followed the so-called "emancipation of mind" in 1977 and 1978. The same mentality of the Party was behind the change around the November 1993 decision.

At the same time, the political will of the Party is also shaped by geo-politics. By the early 1990s, the pressure from East Asian countries was growing, with the perceived "East Asian Miracle" and increased foreign investment from that region. More importantly, the collapse of the

Soviet Union at the end of 1991 changed the geo-politics forever. Both Eastern European and the former Soviet Union countries started radical transition to markets. The Party felt that its power would be undermined if those newly democratized countries soon catch up with China in terms of economic development.

### *C. The Economic Motivation*

The political will of the leadership also met with the economic reality. From the late 1970s to the early 1990s, the economic landscape of China changed dramatically. In the late 1970s, the state sector was a dominating sector. No longer true fifteen years later. The non-state sector became the engine of growth. The first was the big success in agriculture when the commune system was dismantled and replaced by household farming. Then came the booming of industrial and service sectors. By the early 1990s, both the shares of state industrial output and retail commerce accounted for less than 50 percent of the national total. Such a change of economic landscape created new pressures for more radical reforms. What were the pressing economic problems in the early 1990s?

First, the problem of the state sector became increasingly serious. State-owned enterprises underwent a sequence of reforms for more than ten years along the line of "expanding enterprise autonomy and increasing profit incentives." But their performance remained disappointing despite disproportional resource allocation in their favor. For example, the ratio of total profits and taxes to capital in state-owned enterprises declined from 24.2 percent in 1978 to below 10 percent in 1993. Losses from SOEs increased dramatically and non-performing loans accumulated in state banks, accounting for about or over 20% of total outstanding loans.

Moreover, the rise of the non-state sector increased the competitive pressure, which made holding on SOEs more costly than before. The incremental reform of "expanding enterprise autonomy and increasing profit incentives" was not enough, more radical reforms were needed to addressing key issues of property rights, ownership, and corporate governance.

Second, even TVEs need to be reformed, including privatization. Although TVEs played important roles in generating growth in the early period of reform, as they grew and the market matured, many problems arose because of the lack of clearly defined property rights and good corporate governance. The weakness of TVEs became more and more obvious in the early 1990s, for example, in Southern Jiangsu. One problem concerns their internal organizations. As TVEs grew large, they became more and more bureaucratic in management, resembling SOEs. Another problem comes from the increased pressure of market competition. In the managerial labor market, TVEs started to lose good managers to foreign and joint venture firms when the latter give the managers high salary and even shares of their firms. In the product market, fast entry of domestic private enterprises and foreign firms changed the previous seller's market to a buyer's market, eroding the profit margins TVEs enjoyed in the 1980s as early starters.

Third, the old-style administrative control under central planning no longer worked to manage macroeconomic stability in an increasingly decentralized economy. Inflation began to run away in late 1992 and early 1993, which also put pressure on the exchange rate. Both the state and non-state sectors were driving the overheating and the government had little control over it, in part because of the excessive monetary decentralization of the 1980s. A more comprehensive and indirect (or market-oriented) approach to macroeconomic management was imperative (Lou, 1995). This put urgent needs for the reform in the tax and fiscal system, monetary system,



financial system, and exchange rate to tame the increasingly decentralized and market-oriented economy. This is one of the immediate reasons for the November 1993 decision, but the broad scope of the decision shows that it is by no means the only reason.

Fourth, the mixture of market and plan led to rampant corruption and rent-seeking activities. Government officials at all levels used their power over to divert income and strip assets from enterprises for personal gains. They also used their power to collect bribes through granting licenses and land use rights, approving IPOs, exempting taxes, and many other means. The problem is the lack of market-supporting institutions based on the rule of law to constrain the government. As a result, corruption and rent-seeking created a major bottleneck for China's sustained economic growth.

#### *D. The Intellectual Inputs*

The economic factors combined with the political will of the leadership explain the demand for the strategic shift in the mind-set of the leadership. Ideas from economists, on the other hand, provided important intellectual inputs to the November 1993 decision.

Unlike most Eastern European and the former Soviet Union countries, China's reform has never relied on foreign economic advisors. China's reform agenda was shaped by the Chinese themselves. However, the influence of Chinese domestic economists (and some foreign economists) is considerable. Throughout the 1980s, academic exchange with the West and Eastern European countries and new economic education had enormous impact on the old, middle-aged, and young generations of economists. The so-called "western economics," in education and research, has gradually replaced the Soviet-style economics and taken roots in the

economics profession. After more than 10 years of economic reform and academic exchanges, the body of knowledge in China on the market economy and reform increased impressively as compared to that in the late 1970s.

These ideas had important intellectual impacts on the 1993 November decision. In fact, this decision incorporated many ideas coming out of research done in the early 1990s. Some of the key research results was later collected and published in a collective volume (Wu, Zhou, Rong, et al., 1996). Starting 1990 at the low point of economic reform after the Tiananmen incident, a group of researchers worked on the medium-term integrated design of reforms. The research focused on several key areas of reform, including detailed studies on new fiscal and monetary systems, monetary policy in transition, currency convertability, reforms on state commercial banks, financial restructuring of enterprises and banks, social safety net, corporatization, the changing role of government function in the economy, etc. These studies utilized the body of economics knowledge developed in the West, including both neo-classical economics and new institutional economics. In addition, they also incorporated the lessons learned from the reform experience in China and Eastern Europe in the 1980s. The fusion of economic theory with the reform experience has made these studies applicable to the Chinese reality and suitable for policy purposes.

Many important ideas can be traced to the period of intellectual debates on reform strategies in the 1980s. One of the key ingredients of the decision, building market-supporting institutions (such as tax system and financial system), has the intellectual roots in the "integrated reform" school (Wu, Zhou, Lou, et al., 1988). This group of economists recognized early on the shortcomings of piecemeal reforms and emphasized the importance of coordinated reform in

several key areas such as liberalization of prices, building a market-oriented tax and fiscal system, and monetary and financial reforms. They were in favor of a systematic approach and consider a "mini-bang" reform the key to the establishment of a market system. Their proposals were initially accepted but later rejected by the leadership in the 1980s. However, their intellectual contribution had influence for later economic thinking and had specific impacts on the formulation of the November 1993 decision.

Another key ingredient of the decision was on ownership and property rights reform, which also has the intellectual roots in the 1980s. Dong (1979) was the first to recognize the importance of ownership reform. The ideas of property rights, ownership, and share-holding companies were introduced into the Chinese economists circle in the 1980s and that of corporate governance in the early 1990s. The advance of the knowledge of how corporations work in the West has influence on the issues of enterprise reform. The limits of the practice of profit contracting in the 1980s together with the knowledge of the functioning of Western corporations and the stock market contributed to the subsequent decisions on corporatization, diversification of ownership structure, and development of securities market.

#### **4. An Evaluation of the Progress in the First Five Years of the Second Stage (1994-98)**

Starting January 1994 a series of reforms was launched according to the November 1993 decision, mainly in five areas: (i) foreign exchange and external sector reform; (ii) tax and fiscal reform; (iii) financial reform; (iv) SOE reform; and (v) establishment of a social safety net. In this section we evaluate the progress made in the first five years in these areas.

### *A. The Foreign Exchange and External Sector Reform*

Before 1994, liberalization of foreign exchange markets, like many other markets, followed a dual-track approach and there existed an official rate and a "swap rate" (i.e., the market rate). Because of the dramatic growth of the market track, by 1993 the share of the plan allocated foreign exchange had fallen to less than 20 percent of the total. On January 1, 1994, plan allocation of foreign exchange was completely abolished, and the two tracks were merged into a single market track. However, for those organizations which were used to receiving cheap foreign exchange, annual lump-sum subsidies in the domestic currency sufficient to enable the purchase of the previous allocation of foreign exchange were offered for a period of three years to compensate for their losses. In December of 1996, China went one step further and announced current account convertibility of its currency. However, it did not move to capital account convertibility and retained capital control. This is one important reason that China weathered the Asian financial crisis well, given its weak financial system to start with.

We rate the foreign exchange reform as excellent. Between 1994 and 1998, the exchange rate remained stable and even appreciated slightly from 8.7 yuan per US dollar to 8.3 yuan per US dollar. Following the reform, both exports and foreign direct investment (FDI) increased dramatically, and the country's foreign reserves increased from US\$21 billion to US\$145 billion. Despite the Asian financial crisis, China continued to attract FDI of about US\$45 billion annually in 1997 and 1998.

## *B. The Tax and Fiscal Reform*

Before 1994, the fiscal contracting system had played a positive role of providing badly needed incentives for local governments. But fiscal contracting was ad hoc not rule-based. Under central planning, China had never had a national tax bureau, and there was no such need because all taxes were collected by local governments and turned over to the central government. After the 1979 reform, local governments often used their authority to reduce or exempt taxes that were supposed to be paid to the central government.

On January 1, 1994, China introduced major tax and fiscal reforms more aligned with international practices. This reform introduced a clear distinction between national and local taxes and established a national tax bureau and local tax bureaus, each responsible for its own tax collection. This tax reform has made it very difficult for local governments to erode national taxes as they did in the past (Dong, 1997). Reform also established fixed tax rules between the national and local governments. For example, under the new system, the value-added tax (VAT) became the major indirect tax shared by the national and local governments at a fixed ratio of 75:25. But local governments were compensated for their revenue losses for three years.

In 1995, the new "Budget Law" took effect. It prohibited the central government from borrowing from the central bank and from deficit financing its current account. The central government can only have deficit financing in its capital account although it had to finance the deficit with government bonds. It also imposed more stringent restrictions on local governments: Local governments at all levels were required to have their budgets balanced (as before), and furthermore, the law strictly controlled their bond issuance and restricted their borrowing in the financial market (a change from the past). To ensure enforcement of the "Budget Law," an

independent auditing system was also introduced. For example, in 1996 the State Auditing Agency audited the Ministry of Finance's implementation of the state budget for the first time since the founding of the People's Republic in 1949 (Dong, 1997). Tax reform, together with the implementation of the "Budget Law," made local governments' budget constraints much harder.

The 1994 tax and fiscal reforms are perhaps the most profound and comprehensive institutional transformation made in the time period. The decline of government budgetary revenue as share of GDP stopped and reversed. These shares continued to decline from 11.2% in 1994 to 10.7% in 1995, but then increased to 10.9% in 1996, 11.6% in 1997, and further to 12.4% in 1998 (*China Statistical Yearbook*, 1999). The share surpassed 13% in 1999. On the other hand, there remain many unsolved thorny issues, top on the list are the revenue transfer problem between the central and local governments, the troubling sub-provincial tax and fiscal system, and the problems related to extra-budgetary and off-budgetary fees and funds. We can only say that the progress in tax and fiscal reforms had a reasonably good start, but the reform remains far away from finished.

### *C. The Monetary and Financial Reform*

China's monetary system before 1994 was in bad shape. Before 1994, 70 percent of the central bank's loans to state commercial banks were made by the central bank's local branches, which were heavily influenced by the local governments. In 1993, the central bank centralized its operation after Vice Premier Zhu Rongji became its governor. Since then, its local branches have been supervised only by the headquarters of the central bank, not as before also by the local government of the region in which they reside. In 1995 China passed the "Central Bank Law" to

give the central bank the mandate for monetary policy independent of the local government. These reforms substantially reduced the local government's influence on monetary policy and credit allocation decisions (Xie, 1996). This is one of the main reasons that the overall budget constraints of local governments became much harder in the 1990s than in the 1980s: through fiscal channels, because of the tax reform, and through financial channels, because of the monetary reform. In 1998, the central bank further replaced its 30 provincial branches with 9 cross-province regional branches as in the U.S. Federal Reserve system. The nine regional branches are located in Shenyang, Tianjin, Jinan, Nanjing, Shanghai, Guangzhou, Wuhan, Chengdu, and Xi'an. This reform further minimized the local governments' influence on monetary policies. We give a good mark to the monetary reform.

In contrast, we consider the banking and financial reform very limited and unsatisfactory. Since 1994 limited progress has been made to commercialize four major state banks -- Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, and Construction Bank of China, which account for more than 80% of total outstanding loans. After the passing of the "Commercial Banking Law" in 1995, these banks began to adopt the international accounting standard for bank assets and risk management, and became more conscious of profitability and the quality of loans. They also started to compete with each other when their business dealings overlapped. Their operations came one step closer to conventional commercial banks after the central bank in 1998 abandoned the credit allocation ceilings and replaced them with standard reserve requirements, assets-liability management, and interest rate regulations. They do not face any competition from foreign banks, even though foreign banks were allowed to open branches in China, because the latter could not conduct local currency business and mostly restricted to

special economic zones and some major cities.

On prudential regulation, China has basically followed the old U.S. model along the lines of its Glass-Steagall Act; not only is commercial banking separated from investment banking, but also commercial banks cannot hold shares of stock in companies. Three different government agencies now separately regulate commercial banks, security firms, and insurance companies. In 1998, for the first time, several high profile banks and investment companies, such as Hainan Development Bank and Guangdong International Trust Investment Company (GITIC), went bankrupt and were closed down.

Despite the large amount of capital infusion into the four state banks in 1999, the status of the banking and financial system by the end of 1998 was perhaps even more fragile than that in 1994. This is mainly because of the delay of reform in SOEs and the governance of state banks. Lack of SOE reform means that non-performing loan problem became worse and worse. The governance of the four state banks did not have any significant improvement: they remained to be 100 percent state owned, and administratively subordinated to the central bank.

#### *D. The State-Owned Enterprise Reform*

China did not privatize any state-owned enterprises prior to 1992. China's industrial SOEs were dominated by small- and medium-sized enterprises. Most of these enterprises were under the supervision of county and city governments. Privatization of small-sized SOEs began to emerge on a large scale in 1995 (Cao, Qian, and Weingast, 1999).<sup>2</sup> It started by local

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<sup>2</sup> The Chinese do not use the term "privatization," relying on several other terms, such as "transformation of ownership" (*zhuanzhi*) or "readjustment of ownership structure" (*suoyouzhi jiegou tiaozheng*). Similarly, the Chinese often use "non-public ownership" as a substitute for "private



governments as experiments in a few provinces, such as Shandong, Guangdong, and Sichuan as early as in 1992. Later in 1995, the central government endorsed it with the slogan of "grasping the large and releasing the small" (*zhuada fangxiao*). Although the process slowed down in 1998 partly because of the Asian economic crisis, the speed of privatization picked up again in 1999. Overall, privatization of small SOEs had very uneven development across provinces, with some provinces moving very fast (such as Zhejiang, Guangdong, and Shandong) and others lagging behind (such as Northeast China).

Many SOEs are either not viable or are overwhelmed with excess employment, and for them reallocation of labor is the main concern. About ten million workers from SOEs and urban collectives were laid off in each year between 1996 and 1998. Ironically, such mass layoffs and associated unemployment were often painted as serious "problems" of the Chinese reform by the mass media. In fact, they should be viewed as significant achievements of the second stage reform: Never before were state employees laid off and state enterprises closed down, and the layoffs is the essential first step in any serious SOE reform. In contrast, the lack of labor shedding in Russian enterprises even after privatization is clearly a sign of failure rather than achievement. In recent years, total state employment in China started to shrink after reaching a peak in 1995, and declined to below 100 million (including government agencies as well as state enterprises), the level of the late 1980s (*China Statistical Yearbook*, 1999).

However, on ownership and governance issues, reforms in large-sized state-owned enterprises had no breakthroughs. But the failure of several attempts in the past years was quite revealing. First, in 1997, there was an experiment of 100 large state-owned enterprise reform.

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ownership."

The original purpose was to corporatize these SOEs by introducing several investors in each of them, but it ended up with more than 80 of them remaining sole state owned. Second, many corporatized SOEs, including those already listed on China's two stock exchanges, suffered from the conflict between the so-called "three old committees" (the Party committee, the employee representative committee, and the workers union) and "three new committees" (meetings of shareholders, meetings of board of directors, and meetings of supervisory committee). In some cases, the conflict between the Party secretary and the top manager (such as Board Chairman) is so severe that it interferes enterprise's normal operation. Third, in response, some enterprises opted to place the same person in both the positions of Party secretary and Board Chairman. But this leads to another problem: "insider's control." Fourth, to address this problem, starting 1998, hundreds of external "special inspectors" (*jicha tepaiyuan*) were sent by the central government to large SOEs to supervise their operation. However, these inspectors were mostly retired high level bureaucrats who had no knowledge about business operation and financial accounting. Not surprisingly, they could not play any constructive role in addressing the corporate governance problem. Fifth, after abolishing "special inspectors," the government came up another solution by setting up "Large Enterprise Working Committee" (*daqiye gongwe*) inside the Party's Central Committee responsible for making appointments of top managers in large SOEs directly (in collaboration with the Ministry of Personnel). It is sad to see that after so many years of reform on large SOEs, China went a full circle and almost returned to where it started.

### *E. Establishment of the Social Safety Net*

The establishment of the social safety net is regarded as essential for both more radical reform of SOEs and healthy development of private enterprises. In China, the social safety net mainly concerns about urban residents and consists of four programs on pension, health care, unemployment insurance, and minimum living standard support respectively. So far China does not have a unified national program on the provision of social safety net. Rather, provincial and municipality governments are responsible for implementing their own local programs on social safety net.

Financially, the most costly programs are the ones concerning pension and health care, especially the former. The general goal of the pension reform according to the November 1993 decision is to move from enterprise-based pension system under central planning to the one combining "social responsibility" and "individual accounts," the former follows the "pay-as-you-go" principle and the latter is a "fully funded" program. After several years of efforts, such a pension scheme already covered, at least nominally, the employees in almost all SOEs and urban collective enterprises and in more than half of private enterprises. However, two serious problems remain unsolved. The first problem concerns the proportion between the social responsibility and individual accounts, some advocating for a small social account and a big individual account, others for the opposite. The related second problem is the compensation issue for old and retired employees, who cannot contribute sufficient amounts to their individual accounts. Many old industrial cities having higher proportion of old and retired employees face more serious challenges in pension reform, and they are more inclined to go for smaller individual accounts in order to pay for the immediate obligations toward current retirees.

In 1997, the State Council introduced the following framework: the mandatory amount of 11% of payroll should go to individual accounts, of which 8% contributed by employees and 3% by enterprises; and local governments decide on the amount of the part of social responsibility, often around 17% of payroll. Under this framework, individuals contribute 8% and enterprises contribute a total of 20% of payroll. This poses two problems. The total tax rate for pension purposes is too high, around 28% of payroll. This increases dramatically the labor costs of enterprises. Second, the compensation problem for old and retired employees is not solved. The original proposal of using part of state assets or government bonds for compensation is not implemented. As a result, most individual accounts of old employees are still empty, who continue to rely on the "pay-as-you-go" mechanism. This practice also erodes the individual accounts of new employees, because some of their contributions are used to pay the current retirees. This will certainly create the problems for the future, defeating the purpose for creating fully-funded individual accounts.

## **5. Challenges Ahead**

At the beginning of 2000, China faces pressing need for further reform for two basic reasons. First, China's economic growth slowed down in 1998 and 1999, partly due to the Asian financial crisis, but it was also because of the sluggishness of the reform in key areas. To revitalize China's economy, it became essential to speed up the unfinished reforms. The second reason is China's imminent accession to the WTO. The nature of the agreements between China and other countries on the terms of accession has made it rather urgent for China to push its domestic reform more rapidly, otherwise, foreign competition could throw a devastating blow.

Thinking positively, the pressure from joining the WTO provides political momentum for further economic reform. Therefore, now it is a good time to push for the next wave of reform along the direction put forward in the November 1993 decision and subsequent decisions.

*A. What is the Core Issue?*

Our above assessment of the first five years of reform since 1994 is mixed. Although the reform was on the right track and made several impressive strikes, it was disappointing in many areas. To complete its transition to a modern market economy and realize its full potential, China faces numerous challenges. One can prescribe a long list of what should be done. For example, each of the above five areas has unfinished agenda, and to that list one may add needed reforms in regulation and competition policy, improvement in social equality, crack down on corruption, etc. Instead of studying a comprehensive list of issues, we ask the following question: what is the core issue?

In our view, the core issue, which connects to many of the issues listed above, is establishing a system of free and competitive enterprises where the underlying key is the change of government-business relationship into the one of arm's-length type. Specifically, addressing the core issue requires to undertake the following three tasks: (i) transforming existing state-owned enterprises; (ii) promoting new private enterprises; and (iii) establishing the rule of law. If the first two concern the governance of firms, the last one concerns the governance of economy as a whole. The three tasks are closely related. Without being transformed, state-owned enterprises would continue to divert resources away from private enterprises and even suppress their growing up. On the other hand, the development of private enterprises also requires the support from the

rule of law, because the government needs to be constrained by law and the market needs the level playing field. In the end, solving the core issue means the dismantling of what Lenin termed the State Syndicate of the economy, or the Party-State Inc., and the establishing of an economy basically insulating from politics.

Scholars studying the institutional foundations of economic development emphasize the nature of government-business relationship. Economic historians, such as North (1981) and Rosenberg (1986), attributed the rise of the West in the 18th and 19th centuries to the fundamental change of government-business relationship. They cited a sequence of events, such as the Glorious Revolution in England in 1688 and commercial codes and company laws developed later, in insulating businesses and commerce from arbitrary intervention from the government. Through these institutional evolution, the government in the West eventually was able to keep an arm's length distance from economic activities. This provided the room for entrepreneurial activities which were largely free from government intrusions. Scholars on contemporary economic systems drew similar lessons, although from a different context. For example, in his study of socialist economies, Kornai (1992) considered the Party-State control over the economy and the resulting bureaucratic coordination of economic activities as the main cause of the recurrent problems in those economies.

Addressing the core issue provides a key link to many other reform issues. Take government fiscal revenue as an example. Some economists tend to regard the insufficiency of government revenue as the source of many problems such as inflation or regional inequality or lack of a social safety net. But a deeper problem behind the fiscal revenue issue is the problem of state-owned enterprises. SOEs are the government's main source of revenue and also its main

fiscal burden. Similarly, the financial sector problem has a deep root in state-owned enterprises as well because it is the SOEs that accumulated massive bad loans, and in addition, state banks who lent these loans are themselves state enterprises. Consider the issue of establishing a social safety net. The main obstacle concerns the compensation for old and retired employees which demands for a piece of state assets to be endowed in individual accounts. This again requires enterprise reform. As for external reform and further opening up, if domestic reforms lag behind and the government continues to stand in way of business, domestic enterprises would lose to foreign firms in competition. This would lead to backlash against opening up. Finally, addressing the core issue is also beneficial to some social concerns, for example, the rule of law is instrumental to fight corruption.

### *B. Transforming State-Owned Enterprises*

The first task of severing the close relationship between the government and business enterprises concerns transforming SOEs. State-owned enterprises still account for about one-quarter of industrial output, and much more in such services as wholesale commerce, transportation, communication, and banking. The state has a virtual ownership monopoly in such sectors as airlines, telecommunication, and banking. Large scale SOEs still constitute the backbone of the economy. The state sector continues to place a disproportionately large claim on economic resources. For instance, SOEs' share of bank lending remained near 60 percent by the end of 1998. Although SOEs remain the main revenue source for the government (they account for more than one half of total government revenue), they also represent a big financial burden for it. Despite two decades of reforms, the financial performance of SOEs continues to decline and is

ultimately responsible for the financial sector's problem.

The recent document on SOE reform adopted by the Fourth Plenum of the Fifteenth Party Central Committee in September of 1999 (*China Daily*, September 27, 1999) may be the start of a major breakthrough. Three new policies are most significant. The first, and perhaps most important, new policy is "readjustment of the layout of the state economy" in the sense to narrow dramatically its scope. Specifically, the state has decided to concentrate its control over enterprises of four main types while gradually withdrawing from other areas. The specified four areas for control are (i) industries related to national security; (ii) natural monopolies; (iii) industries providing important public goods and services; and (iv) pillar industries and backbone enterprises in high and new technology industries. Currently, SOEs are operating in almost all sectors of the economy, ranging from fighter plane production to hotel operation, from book selling to toy making. Committing the government to withdrawing from most industrial and service sectors is a significant and encouraging step forward in transforming the state sector in the economy.

However, we note that the above policy could have been better. The most controversial aspect concerns the fourth area, the so-called pillar industries and backbone enterprises in high and new technology industries. The inclusion of this provision appears to be a political compromise. It is vaguely defined and could include many industries, such as banking, telecommunication, or the internet. We should not be surprised by politicians' effort to use this loophole for slowing down privatization.

The second new policy concerns the diversification of ownership structure for those enterprises over which the state still wants to maintain control. Except for a few enterprises in



which the state intends to retain 100% ownership, all other enterprises will become joint stock companies with multiple owners. These new owners can be either domestic private investors or foreign investors. The government regulatory body, the China Securities Regulatory Commission (CSRC), has already been authorized to promulgate the regulations on selling state shares. This policy change is also quite significant. Just a couple of years ago when the government selected 100 large SOEs for reform experiments, as many as 80 enterprises out of 100 in the end had the state as a single owner.

Diversification of ownership structure of large-scale SOEs already started in 1999. We give three examples. The state telecommunication monopoly was broken up early that year. Four companies were formed and each of them is actively seeking listings abroad. Among them, China Telecom (Hong Kong) was already listed on the Hong Kong Stock Exchange. Other three companies are all in preparation to be listed abroad. With the abolition of oil and chemical ministries, a reorganization produced two national petrochemical companies, namely, the China National Petroleum Corporation (CNPC) and the China Petrochemical Corporation (SINOPEC). The IPO of PetroChina, a subsidiary of CNPC, was completed in early 2000. The third example concerns the Legend Group, the largest PC maker in China. Established in 1984, the company was 100% state owned. Early this year, the company distributed 35% of its shares to its managers, engineers, and other employees. The Legend Group has set up an example for other state high-tech companies to distribute shares to their employees.

The third new policy concerns the establishment of corporate governance, the very term appeared in a Party document for the first time. Once a firm has several investors, the demand for corporate governance emerges. Corporate governance is a set of institutional arrangements

governing the relationships among investors (shareholders and creditors), managers, and workers. The structure of corporate governance concerns (i) how control rights are allocated and exercised; (ii) how boards of directors and top managers are selected and monitored; and (iii) how incentives are designed and enforced. In market economies, major issues of corporate governance concern legal rules limiting the agency problems, protecting shareholders and creditors, and providing room for managerial initiatives.

We expect corporate governance reform to be the most difficult to implement of the three new policies affecting SOEs. The difficulty arises because of the political position of the Chinese Communist Party. Although the past SOE reform adopted various reform policies, the fundamental principle of "Party controlling personnel" remained unchallenged. The Party not only appoints cadres to administrative posts but also managers of state-owned enterprises. The combination of expanding enterprise autonomy and the power of the Party over personnel has led to a dilemma (Qian, 1996): Delegating more effective control rights to managers provides them with incentives to increase current production, but also enables them to plunder state assets, which results in high agency costs. On the other hand, maintaining Party control over the selection and dismissal of managers serves to check managerial asset stripping somewhat but is also the ultimate source of political interference.

As for the Party's role in corporate governance, the recent decision on SOE reform sent out a mixed signal. On the one hand, the government intends to follow the international common practice in hiring, empowering, and rewarding top managers for its enterprises, including giving them stocks. On the other hand, the decision reiterated the fundamental principle of "Party controlling personnel," although it also said that the "controlling methods" will be improved. The

Party control gives the enterprise Party Committee extra-ordinary power in making strategic decisions, and thus it presents a fundamental problem in corporate governance.

In the coming years we will see conflicting forces on corporate governance reform. Withdrawing the Party from managerial appointments is the first test of the political limits of economic reform. Unless the state, institutional investors, and individual investors are put on an equal footing, political intervention by the government will continue to plague the performance of these firms. The issue of the Party's role must be addressed before the goal of "separation of government and enterprise" can be achieved. For this reason, corporate governance for large state-controlled enterprises remains to be one of the most thorny issues.

**The case of reforming state banks.** A lot of studies of the financial system problem focuses on non-performance loans. But the ultimate problems of the financial system are SOEs and state-owned banks. State banks are simply state-owned enterprises in banking business. Currently, the state owns 100% of all four state commercial banks, which account for more than 80% of total outstanding loans, through the legal form known as "sole state ownership" (*guoyou duzi*). A useful reform is through diversification of banks' ownership structure to make them truly commercial banks, and further to build up their corporate governance. In this regard, we expect two possibilities, each can find precedent in China's own experience.

The first possibility is partial diversification of state ownership through the issuance of bank shares to the public in the domestic or overseas stock markets. Recently, Pudong Development Bank of Shanghai issued 400 million yuan (\$48 million) worth of shares to the public and made the bank listed on the Shanghai Stock Exchange. Traditionally, households in developing countries favor bank stocks and regard them as "blue chips." Issuance of bank shares

may also help rejuvenate the Chinese stock market. Therefore, the experience of Pudong Development Bank provides one possible model for the four major state commercial banks. Diversification of ownership to include the public is one way to force a bank to set up better corporate governance.

The second possibility is to follow the example of the Communication Bank of China. Established in 1987, this bank is the fifth largest bank in China. It is arguably the best run bank in China, being the most profitable and having the lowest proportion of non-performing loans in its assets. This bank is a joint-stock bank (but is not listed on the stock market), and its shareholders are other state-owned enterprises and organizations. These investors have strong financial interests in the healthy operation of the bank, although ultimately all the shares of the bank are owned by the state. The corporate governance of this bank is quite different from that of the four major state banks; the former does not have a direct administrative link to a particular government agency but the latter do. Diversification of ownership to include multiple institutional investors is another way leading to better corporate governance because one state administrative organ does not possess monopoly control any more.

Through either method, we expect the state to continue to hold majority shares of the four major banks in the near future. The performance of these banks can still be improved with better corporate governance and more competition, especially competition from foreign banks after China's accession to the WTO. In many other countries, privatization of banks often came later than privatization of industrial firms. In Taiwan, for example, most banks are state owned. Also in Germany, more than one half of banks (in terms of assets) are still publicly owned, mostly by local governments. These banks do not appear to perform too badly as compared to private

banks. This is perhaps because banks have to be regulated by the government anyway and thus the entrepreneurial scope for operating a bank is smaller than that of operating an unregulated firm, provided regulations are well enforced.

The Chinese government launched two reform programs to clean up the accumulated non-performing loans in state banks. The first is the creation of four Asset Management Companies (AMCs) -- Xinda, Dongfang, Changcheng, and Huarong -- to take over respectively non-performing loans of the Construction Bank of China, the Bank of China, the Agricultural Bank of China, and the Industrial and Commercial Bank of China. The second and related program is the "debt-equity" swap intended to reduce the debt burden of selected SOEs. Because the Chinese banking law does not allow commercial banks to hold equity, the newly established AMCs are made responsible to implement the debt-equity swaps.

While both AMCs and debt-equity swaps can be useful, they are not substitute for banking reform described above, and moreover, we have serious concerns about their implementation. Transferring bad debts from state banks to AMCs and debt-equity swaps by themselves are merely accounting exercises, because the state still owns the bad assets of SOEs through its ownership of AMCs. These exercises by themselves do not address the crucial problem of banking reform, i.e., the governance of state banks. Worse, large scale transfers of bad debts and debt-equity swaps might introduce the moral hazard problem to state banks and state enterprises: When done unconditionally, the state is actually handing out cash, like emergency blood transfusion, to save troubled banks and enterprises.

### C. Promoting Private Enterprises

The second task of establishing arm's length relationship between government and business is the promotion of private enterprises, especially small- and medium-size enterprises (SMEs). By 1998, private enterprises in the Chinese industry accounted for 37% of total industrial output (Table 1). Although private enterprises accounted for more than 50% of retail sales of consumer goods (Table 2), they accounted for much less in other services. For example, in service sectors such as telecommunication and banking, private enterprises virtually do not exist.

Ten years ago at the beginning of transition in Eastern Europe, economists paid great attention to mass privatization of large-scale state-owned enterprises, and they believed that such a privatization would soon lead to superior performance. Voicing a minority opinion, Kornai (1990) argued that, rather than focusing on mass privatization of existing state-owned enterprises, transition economies would be better off by promoting *de novo* private enterprises created by entrepreneurs. These entrepreneurial firms always started small, and, because entrepreneurs have substantial personal stakes in the firms, they would be better positioned to avoid many of the pitfalls in governance that beset large firms at the initial stage of transition.

Evidence from Eastern European transition in the last decade demonstrates that growth indeed came from the *de novo* private enterprises which were mostly SMEs. The striking example is Poland, which had not implemented any mass privatization of large-scale state-owned enterprises because of workers' opposition, not a surprise in a country where union exert strong political power. Despite (or because of) this, Poland is one of the most successful transition economies, due mostly to the newly created private enterprises. Like their counterparts in

Eastern Europe, Chinese economists in the past two decades spent much time and energy debating on how to reform (including privatize) large-scale state-owned enterprises. China's own experience demonstrated that the growth impetus mainly comes from the sector of small- and medium-sized enterprises, the phenomenal growth of TVEs being a good example.

Even in market economies, developed or developing, newly created small- and medium-sized firms played important roles in economic growth. The boom of the U.S. economy in the 1990s benefitted greatly from the deregulation and structural changes in the 1980s, where more and more small enterprises entered previously monopolized industries and new high-tech companies mushroomed. In Silicon Valley, new start-up firms emerged at a record rate, becoming the pillars of the internet revolution. In Taiwan, the phenomenal growth of the high-tech industries was driven largely by entrepreneurial small- and medium-sized firms. In recent years, Taiwan's electronic industry overtook that of South Korea, which relied more heavily on a few big conglomerates (*chaebol*), to become the third largest producer in the world after the U.S. and Japan.

Development of private enterprises in China may take three forms. First, *de novo* private enterprises initiated by entrepreneurs. The Chinese do not lack entrepreneurship. The bottleneck is the legal protection of entrepreneurial activities. Recently, China's National People's Congress passed the "Law on Individually-Owned Enterprises," which provides, for the first time, legal protection for entrepreneurial firms.

Second, privatized small- and medium-sized state-owned enterprises. The 1995 government policy of "releasing the small" was further relaxed to "releasing the small and the medium" in the Decision of September 1999 on SOE reforms (*China Daily*, September 27, 1999).

Its impact on the development of private enterprises can be quite significant. This is because in China, unlike Eastern Europe, the distribution of SOEs by size is skewed toward small enterprises. In 1993, small- and medium-sized state firms employed about 67% of state workers and produced about 43% of state industrial output (Table 3). Even without any privatization of large state-owned enterprises, merely by releasing the small- and medium-sized SOEs, the share of state industry would be reduced by almost half.

Third, privatized collective enterprises. By 1998, collective enterprises accounted for about 36% of total industrial output and most of them are Township-Village Enterprises (TVEs). TVEs were the growth engine of the 1980s and early 1990s, but their competitive advantage gradually declined. Since 1995, more and more TVEs have been transformed into "stock cooperatives" or outright privatized.

Private enterprises will develop faster if the government can provide a better institutional environment. We highlight two policy issues. The foremost concerns further liberalization to eliminate ideological and political discrimination against private enterprises. Although the recent Constitutional Amendment has already established private ownership as an important component of the economy, various types of discrimination against private ownership remain. For example, initial capital requirement for registration of a limited liability company is about \$60,000, one of the highest in the world. In addition, China also has one of the most complicated bureaucratic procedures to open a private business. The second concerns the creation of more favorable financing channels for small enterprises. Smaller banks and credit cooperatives may have advantage in financing local small firms. In restructuring financial institutions, the government should not exclusively focus on the large banks and should give adequate attention to small



enterprises' financing needs.

**The case of Zhejiang province.** The development of private small- and medium-sized enterprises will likely become the new growth engine and the brightest spot of the Chinese economy in coming years. Our optimism is supported by the recent evidence from Zhejiang province that has fastest development of private enterprises, from which we see the future development trend for the rest of the country.

Zhejiang province, just immediately south of Shanghai, is the mid-point of China's coast line. It has a population of 44 million, the same size as that of South Korea. For some time before 1978, Zhejiang was a median performer among 29 provinces in terms of economic development. Two decades later by 1998, however, Zhejiang jumped to the fourth position in total GDP. It accounted for 10 percent of the national industrial output, ranking third behind Guangdong and Jiangsu provinces. In 1998 and 1999, while the national economy slowed down, Zhejiang kept its momentum and became the star performance province of China. In 1998, for example, its GDP grew at 10.1%, compared to a national average of 7.8%.

Zhejiang's outstanding economic performance can be attributed to the super fast development of its private enterprises. In the 1990s, private enterprises grew at an amazing speed. By 1998, the shares of industrial output in the state, collective, domestic private, and other types (including foreign and joint venture) enterprises were 11%, 32%, 45%, and 12% respectively. In 1998, for the first time in its history, the private sector on its own contributed more than 50% of Zhejiang's industrial output. Nor surprisingly, Zhejiang province has the lowest share of state industry in the country as well (*Zhejiang Online*, September 1, 1999). Zhejiang has become the first of 31 provinces in which private industry accounts for more than one half of

industrial output. Within Zhejiang, among the 20 fastest growing counties, the share of private industry exceeds 50% in more than 2/3 of them.

More interestingly, private enterprises in Zhejiang started to take over ailing state enterprises. For example, in 1999, Renmin Electronic Equipment Group, a private enterprise from Wenzhou, bought 230 *mu* (15 hectare) land in the Pudong area of Shanghai for its electronic equipment manufacturing facility. At the same time, it acquired 34 state-owned enterprises (SOEs) in Shanghai. Most of these SOEs are loss-making but are endowed with premier locations, in addition to some technological, and human capital advantages. The private enterprise had a complex with 6 subsidiaries and more than 300 sales companies all over China, with the total sales of 300 million yuan (\$36 million) in 1998 (*People's Daily*, September 17, 1999).

Several other features of the private enterprise development in Zhejiang are worth mentioning. First, private enterprises in rural areas are the main driving force in Zhejiang's industrialization. Between 1992 and 1997, 3/4 of the increase of industrial value added came from rural enterprises. A further breakdown in 1997 shows that private enterprises turned out 2/3 of rural enterprise output (*Zhejiang Online*, September 1, 1999). Second, as a coastal province, Zhejiang does not boast a particularly impressive record in attracting foreign direct investment (FDI). FDI accounts for less than 10% of industry. Domestic private enterprises have been the primary force in its impressive development. Third, Zhejiang also mainly relies on domestic markets not export for its development. Zhejiang's development seems not to fit in either the strategy of import substitution nor that of export-orientation.

Zhejiang represents China's future. In historical perspective, Zhejiang had lead the country

in ownership changes. In 1984, the share of non-state industrial output (collective and private) in Zhejiang was already more than 50 percent, at the time the national average was 35 percent. Eight years later, in 1992, the national average of non-state industrial output rose to over 50 percent. In 1998, the share of private industry surpassed 50 percent in Zhejiang while the national average stood at 37 percent. Recently, many provinces sent out "study groups" to visit Zhejiang to find out why it grew faster than other provinces. The lesson is clear: faster development of private enterprises. With other provinces learning from Zhejiang's experience, we would not be surprised to see the share of private industrial output at the national level surpass 50% within the next decade.

#### *D. Establishing the Rule of Law*

Both transforming state-owned enterprises and developing private firms need a fundamental change of the rule of the game. Ultimately, changing the government-business relationship into an arm's-length type requires the establishment of the rule of law. Interestingly, the Chinese government has separate legal reform from other "political reforms," which allowed it to make considerable progresses in the past few years. In 1996, China's parliament passed the "Lawyers' Law," which is considered by many as a milestone for the legal reform. Public hearings, open trial, and even live TV coverage of trial followed, although still in limited scope. The Constitutional Amendment of March 1999 that incorporates the principle of the rule of law is another major development.

The economic advantages of the rule of law over ad hoc arrangements are transparency, predictability, and uniformity, which reduce idiosyncratic risks, rent-seeking, and corruption.

These features will in turn reduce transaction costs and increase economic efficiency. Therefore, the rule of law is more than putting the government's words into public codes; it fundamentally concerns the rule of the game in a modern economy governing the relationship between the state and markets that is most conducive to economic development.

There are two economic roles of the rule of law. The first is that the law should be applied to the government -- the government needs to be constrained by law vis-a-vis other economic agents in the market. Through the rule of law, the government binds itself and thus makes a credible commitment to the provision of private incentives, which are the ultimate force for economic development. This role of the rule of law provides a foundation for a limited government and secures private property rights against government intrusion. By reducing government discretion, the rule of law is also a powerful instrument to limit corruption and rent seeking.<sup>3</sup> Under the rule of law, individuals have the rights to sue the government. Recently, private businessmen and farmers began to use legal means to protect themselves against excess government fees. For example, *The Wall Street Journal* (March 25, 1999) reported the case of Peijiawan village in Shaaxi Province, where 12,000 farmers in 1996 filed a class-action lawsuit against the local government for levying excess fees of \$75,000. In the fall of 1998, the local court made an initial ruling in favor of the farmers. The local government appealed, and the case was before the Shaaxi Provincial Supreme Court at the time of reporting.

The second economic role of the rule of law is that the government needs to protect private property rights, to enforce contracts, to create a level field for competition, and to regulate the market if necessary. To achieve this goal, the government needs to become a neutral

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<sup>3</sup> Democracy is another way to limit corruption. China has held elections only at the village level.

third party, making a fundamental shift from its role of manager or administrator of economic activities under central planning. In early 1998, a major reform to streamline the government bureaucracy took place. The number of ministries in the central government was trimmed from 45 to 29, and the number of civil servants was cut by half, from 8 million to 4 million. Most of the former industrial branch ministries were downgraded to bureau status and placed under the jurisdiction of the State Economic and Trade Commission (SETC). Their previous enterprise management functions were removed and their direct administrative links with state enterprises were severed. One example is the Ministry of Information Industry. This ministry used to directly administer China Telecom, the telephone monopoly in China. After the breakup of China Telecom, the ministry became the regulatory agency for the telecommunication industry, playing the part of the U.S. Federal Communications Commission (FCC). Another example concerns government regulation of financial institutions and markets. With China's accession to WTO and its commitment to grant market access to foreign banks and insurance companies, the need for prudential regulation becomes urgent.

The rule of law is not just a collection of legal codes, which can in principle be copied from other countries or even downloaded from the internet. In China, as in many other transition and developing countries, the most troubling aspect of implementing the rule of law is not enacting laws, but enforcing laws. The impartial enforcement of law and contracts requires an independent and uncorrupted judiciary system. This raises a deep question: Is it possible or feasible to establish an independent judiciary system within the basic framework of a one-Party political system?

In reality, two most serious problems in contract and law enforcement are judiciary

corruption and local protectionism. We will focus our discussion here on the latter. China is a very large country. As a result of two decades of reform and decentralization, most economic decisions are made by enterprises or other organizations connected to the local rather than the central government. Xiao Yang, Chairman of China's Supreme People's Court, considered local protectionism as the top reason for the difficulties in law enforcement, leading to what he called "judiciary localism" (*People's Daily*, September 3, 1999). Judiciary local protectionism biases the judgement in dispute resolution in favor of the party inside the jurisdiction of the court making rulings. In a typical scenario of contract dispute between firm A in province 1 and firm B in province 2, the court in province 1 likely rules in favor of firm A and the court in province 2 likely rules in favor of firm B. Under judiciary local protectionism, contract and law enforcement are not impartial.

**The case for a two-tier judiciary system.** The nature of the problem suggests a solution. Because the central government now usually has an arms-length relationship with local business transactions, we consider it possible to create a two-tier judiciary system to overcome the problem of judiciary local protectionism. In such a way, the judiciary system can be made substantially independent from government influence, although not entirely. But because most business transactions are local, the rule of law can be implemented substantially, even within a one-Party political framework.

In the two-tier judiciary system, the local tier consists of the current local courts: each province (or city and county) maintains its own courts responsible to the corresponding People's Congress under the Chinese Constitution. On top of that, another tier -- the central or federal tier consisting of the Supreme Court and cross-province Circuit Courts under it -- may be established.

Currently, China's Supreme People's Court at the central government does not have facilities to make rulings on disputes involving different provinces. Cross-province Circuit Courts have no interests in local economy and are less influenced by local governments. Thus, the two-tier judiciary system, as compared to the current system, can better sustain impartiality of enforcement of laws and contracts. It appears to be politically feasible too.

The proposed two-tier judiciary system reform shares some features of the recent fiscal reform and central bank reform. In the fiscal reform, a two-tier tax administration system was established where national and local tax bureaus replaced the single tax administration. In the central bank reform, the central bank established 9 cross province regional branches to replace previous provincial branches. In these cases, the reforms substantially reduced local political influence on tax collection and monetary policies respectively. The parallel judiciary reform can have similar beneficial effects on contract and law enforcement.

#### *E. Can the Current Political Institutions Accommodate the Change?*

We have discussed the three major areas to address the core issue. But can these desirable reforms be implemented within China's prevailing political system? There is no easy answer to this important question for several reasons. First, political institutions will respond to economic development and structural change, and thus this is the classical endogeneity problem. Indeed, as in the past, we may see in the future more far-reaching political changes in responding to the demand from economic growth. Second, the meaning of "political reform" also changes over time. For example, legal reform used to be considered as a part of political reform, but not any more. Third, even one takes political institutions and political reform as a fixed concept, there is

no uniform answer to the question because different reforms face different degrees of political constraints.

We group the reforms into three categories according to the current political feasibility. In the first category, reforms are implementable now, that is, the current political institution does not pose any significant constraint. Such reforms include developing small- and medium-sized private enterprises; introducing multiple investors in large-scaled state-controlled enterprises; and public listing and ownership diversification of major state commercial banks.

The second category concerns those reforms that are openly debated now but consensus has yet to be reached. For example, in connection to SOE reform, the issue on reducing the Party's decision making role in large state-controlled enterprises is much debated. Many are in favor of adopting the practice according to the Company Law in which no special role is given to the Party. In fact, as early as in 1980, Deng Xiaoping himself pushed the idea that the Party Committee (*dangwei*) in SOEs should not be involved in the day-to-day decisions of enterprises (Deng, 1993). But still others insist otherwise.

The third category includes those reforms that are not openly discussed right now, but promising indirect resolutions could be adopted. An example is judiciary independence, the very term has been avoided in newspapers. Interestingly, "legal reform" in China has been made separated from "political reform." Just like the concept of market economy, the rule of law is also written into the Chinese Constitution. The political reform, which is currently not on the agenda, mainly refers to free election and freedom of political association. It is not clear how far legal reform can go without political reform. But the possibility exists that substantial judiciary independence can be adopted through innovative legal reforms.



## 6. Concluding Remarks

In 1998, China marked the twentieth year of reform of its economy in the transition from plan to markets. One of the most significant events in the 20-year history of reform was the adoption in November 1993 of a program to guide China to a "socialist market economy." Since then, China's reform entered the second stage to systematically build up market-supporting institutions and to address the problem of state-owned enterprises in a fundamental way.

To assess how far China has progressed across the river, we provided an analysis and an overview of the economic reforms implemented since 1994. We then identified and assessed the core challenges China has to face in order to complete its transition and to realize its full potential. In some areas we observe a clear trend of development (such as private enterprise development), in other areas we expect multiple possibilities unfolding (such as corporate governance of large-scaled state-controlled enterprises), yet in other areas we see only a beginning of change (such as the rule of law).

China has many opportunities to continue its fast growth in the coming years. However, whether the growth potential can be realized depends on whether the reform is able to keep the pace with economic development. From the above analysis, we see the great difficulties ahead. But we are in general cautiously optimistic about China's reform future. After the two decades of successful reforms, the non-state sector has already become the bulk of the economy and the popular support for further reforms has remained strong. These are the fundamental domestic factors that are favorable to further reforms.

Our subscription to the more optimistic view on China's reform future is bolstered by a particular new factor -- China's imminent accession to the WTO. With virtually all major

obstacles being removed by now, China's accession is no longer a possibility, but rather will soon become a reality. The rule of the WTO is the rule of law for global market competition. By joining the WTO, China will become more integrated into the global economy. In order to survive in the global market place, China has no choice but to accelerate its transition to a full-fledged market system incorporating international best practices. Thus, China's accession to the WTO will likely tilt the domestic political balance in favor of further and faster reform. Already, the demand inside China for quickening its transformation of SOEs, development of private enterprises, and establishment of the rule of law became stronger recently than in the past ever. Therefore, the WTO factor will provide an important and timely impetus for China's transition to a market economy.

History is never short of surprises. Twenty years ago few had predicted the huge success of China's economic reform in the subsequent two decades. Past performance is no guarantee of future results, and there are always contingencies that are beyond anyone's predictions. But barring catastrophic events, we remain cautiously optimistic about China's remaining journey toward the other side of the river -- a modern market economy.

Table 1. Ownership Composition in Industrial Output (%)

	1978	1980	1985	1990	1995	1998
State-Owned or Controlled	77.6	76.0	64.9	54.6	32.6	27.0
Collectives	22.4	23.5	32.1	35.6	35.6	36.3
Private	0.0	0.5	3.1	9.7	31.8	36.8

Note: State-owned means 100% state ownership, and state-controlled means the state has 51% or more shares in joint ventures or joint stock companies. Collectives refer to urban collective enterprises and rural township-village enterprises. Private enterprises refer to the rest, including foreign firms.

Source: *China Statistical Yearbook*, various years.

Table 2. Ownership Composition in Retail Sales of Consumer Goods (%)

	1978	1980	1985	1990	1995	1998
State-Owned or Controlled	54.6	51.4	40.4	39.6	39.8	20.7
Collectives	43.3	44.6	37.2	31.7	19.3	16.6
Private	2.1	4.0	22.4	28.7	40.9	62.7

Note: State-owned means 100% state ownership, and state-controlled means the state has 51% or more shares in joint ventures or joint stock companies. Collectives refer to urban collective enterprises and rural township-village enterprises. Private enterprises refer to the rest, including foreign firms.

Source: *China Statistical Yearbook*, various years.

Table 3. State-Owned Industrial Enterprises by Size, 1993

	Number (%)	Output (%)	Employment (%)
Large	4.7	56.7	43.2
Medium	12.9	23.6	25.6
Small	82.3	19.7	31.1

Note: The precise definition of the size of an enterprise varies by industry. Large enterprises are subdivided into "large I" (very large) and "large II," and medium enterprises are subdivided into "medium I" and "medium II." For details, see Appendix III of *China Industrial Economic Statistical Yearbook, 1988*.

Source: Table 1 in Cao, Qian, and Weingast (1999).

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