# Foreword

From the launching of reform and opening-up in 1978 to the dawn of the 21st century, China has been transformed from a self-enclosed, planned economy to a market-based one, and the country has integrated itself into the international community. China wishes to look beyond its border and engage in equal-footed dialogue with its partners and competitors. With China's rapid emergence and great achievements, other countries increasingly want to learn more about this "mysterious oriental country" and the miraculous changes taking place here. However, we have also found that abroad, the public, high-ranking officials and even media and academia may not have a clear picture of China. Chinese scholars' views on their country and beyond are not well understood by foreign scholars, not to mention people in the street, and overseas officials and scholars do not appreciate China's realities. Legitimate claims and well-intentioned expressions from China are often misunderstood or distorted by the media, and it seems that the world is unprepared for a changing China. China needs to know itself and the outside world, and the world needs to have a closer look at China as well. Research on the China phenomenon and its implications has become topical around the world. Hence, developing diversified channels and platforms of communication is necessary both in China and the outside world.

A possible way to meet this need is to express to the world Chinese scholars' opinions and research in a language that foreign readers, understand, particularly mainstream audiences and elites. That's why we launched the semi-monthly English journal *China Economist* in March 2006: to update the world about the latest outcomes of Chinese economics and management research and provide in-depth reports and statistical information about the current economic situation and events in China. There have been more than 400 articles published in this journal, and they have been well received internationally.

This book is a collection of some of the best articles published in 2011 on *China Economist*, and it represents top Chinese economists' major research outcomes and opinions on economic matters, status and trends from various perspectives. Some work with China's highest academic research institutes and policy consultation agencies, while others work with related agencies and universities. Hence, this book largely reflects the key concerns and efforts of economic research institutes, policy advisory agencies, regulatory policy research departments and universities on China's economy.

Since the 1980s, China has been increasingly seen as an economy of great vitality and appeal. Opening-up and robust growth in a country of such magnitude has shocked and worried the world, while China has become one of the developing countries most tolerant and least reserved toward economic globalization. The massive Chinese "dragon" is bringing about a fundamental transformation to the global economic landscape. What implications will such transformation have on China and beyond?

Indeed, rapid economic growth over the past three decades has transformed China and its people's lives. By economic size, China is already a major industrial producer and economic power. However, by per capita income or GDP, China is at most on the boundary between a low-income country and the lower tiers of a mid-income country. By current exchange rates, China is a low-income country. By purchasing power parity (PPP), China is only at the lower tiers of a mid-income country. China has one-fourth of the world's labor, but its GDP is far below the world average of 10%. Even if China becomes the largest exporter in the world, its export share would still be far below one-half the share of its population. In other words, China's output capacity and economic size make up a much smaller proportion than its population. China's per capita GDP is also below world average level. Premier Wen Jiabao has admitted that more than 100 million Chinese people are in desperate poverty. China's social security and basic welfare systems are still very weak. By any standard, China is not a developed and mature modernized country.

Chinese scholars wish to tell the world this truth: Although China has become the world's second largest economy, its GDP per capita is very low. China remains a developing country, and development is its top priority and the basis for all welfare programs. The rights of development are basic human rights upon which China cannot waiver. Development is the best gift China has to offer to the world. Meanwhile, Chinese scholars should also recognize that China must deepen reform and expand opening-up, balance efficiency with fair income distribution, use resources in more efficient, refined and clean ways, and challenge its enterprises to assume more social responsibilities. Only in this way can China complete its historic transition from a developing country to a mature, modernized country.

**Prof. JIN Bei (金碚) and Dr. LI Gang (李鋼)**
February 15, 2012

# CONTENTS

## Part Three: Three Rural Issues



## Part Four: Foreign Trade and Global Economy



## Part Five: Income Distribution

## Part Six: Environmental Regulation

# Part One

# Macroeconomic Operation

# Chapter 1

# Panorama of China's Economic Reforms since 1949

**WU Jinglian** (吴敬琏)

**Professor, Development Research Center of the State Council**

**Abstract**: This paper presents an overview of China's economic development and reform over the past 60 years, mapping out the course of how Chinese people overcame ideological fetters constraints, redirected reform despite barriers and deviations, and brought into contrast the distinction between government and the market. In summary, it reinforces the fact that further reform is the only answer to China's complex economic contradictions.

**Key words**: 60 years of China's economy, reform

Since its founding sixty years ago, the People's Republic of China has come a long way evolving from a planned economy to a market-based system and in terms of economic development itself. Numerous difficulties, turbulences and swings were encountered during this course. Taking stock of this history is essential if China is to cope with new challenges, achieve new breakthroughs, and elevate its status in the international community.

The gun salutes at Tian'anmen Square 60 years ago opened a brand-new era. During the economic recovery from 1949 to 1953, after a series of wars that ravaged the nation's infrastructure and economy, China rose from the ashes and refreshed the landscape of its national economy. But the victory came with a dark side. Behind the brilliant achievements there was a tendency for rashness and exuberance. Establishment of a Soviet-type centralized planned system on the basis of hasty socialist reform had stifled enthusiasm, vibrancy and vitality. This situation impelled policy makers to place reform on the agenda.

Marked by major reform initiatives, this paper divides China's economic reform into three stages. With the benefit of hindsight, the successes and failures are examined with the aim of characterizing the course of China's economic reform and development.

The first stage refers to the period of a decentralized command economy from 1958 to 1978: Reforms focused on decentralization and devolution of power from the central government to local authorities.

The second stage marks incremental reform from 1979 to 1993: Reform was advanced in economic spheres outside the state sector, and the growing private sector provided a strong impetus to the national economy.

The third stage refers to full-scale progression from 1994 till now, characterized by reform on all fronts oriented towards the goal of an enabled market economic system.

In China's reform process, multiple reform initiatives of varying stages run through each other. Reform of the previous stage usually contains certain roots of the next, whereas a later stage of reform often reserves some legacies of an earlier one.

## I. Reform of decentralizing command economy (1958 –1978)

The planned economy came into full swing after the reform of socialist public ownership. Despite early achievements, the disadvantages of this model surfaced quickly. The national economy as a whole was like a "big enterprise" with the central government being the leader and local authorities acting like corporate departments at different hierarchical levels. Enterprises, which should have otherwise run as independent entities, were like the workshops in this "big enterprise."

In this "big enterprise," the central government worked out objectives to be issued to its various "departments" through planning directives, which were then cascaded down to each "workshop." This is an immensely intricate system where collective actions are dictated at the central level with complex and rigid but hardly accurate planning. The national economy seemed to function in an orderly way, yet was prone to inefficiency and inflexibility.

The Chinese government attempted to take actions when the planned economy model proved to be unproductive. Constrained as it was by ideology and having only a limited level of understanding at that time, the adjustments were no more than a few isolated solutions implemented within the framework of the planned economy. What is worse, many of these actions deviated from the intended results when carried out.

It was proved in later practice that reform designed under planned system was unable to remove the intrinsic flaws of the centrally planned economy. Rather, every policy adjustment of the planned economic system, which prohibited initiatives at the micro level, meant a drastic and unheralded social dislocation led by a few elites.

### (I) Delegation of power

During this period, the agenda of adjustment was dominated by delegation of authority to the local level. As the first step in the overhaul of the planned system, certain decision-making powers were delegated to local agencies and competition was stimulated at the local level. However, the country was still run like an enterprise based on administrative diktats rather than market-based price signals. Allocation of resources depended largely on the haphazard precision of prior planning. Planning, execution and executive motivations often led to immeasurable inefficiency, waste and losses.

In 1957, according to the resolution at the First Plenary Session of the 8th CPC Congress held in August 1956, the Chinese government issued an economic reform package featuring decentralization. The decentralization campaign started at the beginning of 1958 and formed a power-sharing command economic system. The government tightened its control on rural economic and social affairs by establishing the political units of "people's communes" that integrated agricultural, industrial, commercial, educational and military activities. Decentralized economic system composed of People's Communes thus became the institutional foundation of the "Great Leap Forward" movement launched by Mao Zedong.

The decentralization of 1958 primarily included the following aspects:

—Decentralization of administrative power. The Central Committee of the Communist Party of China issued a directive in September 1958 that intended to transform the central planned system led by the State Development Planning Commission (SDPC) into one which is balanced at the regional level with inputs from line departments. Under the new system, planning was conducted from a bottom-up approach and the local economy developed independent systems. According to this directive, local government could adjust local agricultural production quotas, make decisions on local construction activities and use of investments, distribute local resources, and keep a certain proportion of surplus products.

—Decentralization of corporate management. On April 11, 1958, the CPC Central Committee and the State Council issued a directive to delegate the administration of all enterprises to local governments except for a few critical, special and experimental ones. In this way, 88 percent of the enterprises and government affiliates were delegated to local authorities and even neighborhood committees and People's Communes. The proportion of enterprises directly under the central government declined from 39.7 percent in 1957 to 13.8 percent in 1958 as a share of overall industrial output value.

—Decentralization of material distribution. First, the SDPC and the State Council remained in charge of the distribution of fewer types and less quantity of materials. Second, even for these materials, their allocation was shifted from the central level to provincial and local levels. Third, on the supply side, local planning authorities became responsible for the distribution and allocation of materials except for those of a few sectors.

—Decentralization of capital construction project approval, investment administration and credit administration. For local projects above a certain threshold, local authorities only had to submit a simple project statement to the SDPC for approval; for those below the threshold, local authorities had full independence in their decision-making. Various programs including large projects above the threshold were allowed within the scope of central fund allocations and local finance. Local banks were allowed to issue loans of "any amount" at "any time" for qualified projects in order to boost production.

—Decentralization of fiscal and taxation authorities. It was decided to practice a "tax contract system" in order to increase local financial power and authority.

—Decentralization of labor management. Labor employment planning was no longer developed and cascaded down by the SDPC. Local recruitment plans could be executed once approved by the governments of provinces, autonomous regions and municipalities.

The reform of 1958 also took measures in the interest of corporate empowerment: (1) Reduce command planning indicators issued by the SDPC to industrial enterprises from 12 to four, i. e., output, employment, remuneration and profits; (2) Reform the system of "corporate bonus" by allowing enterprises to retain all their profits; (3) Expand enterprises' authority of human resources management. Except for supervisors and main technical staff, enterprises had full authority of human resources management including organizational and personnel adjustment without increasing the total number of employees; (4) Enterprises were granted access to certain funds and allowed to adjust and scrap fixed assets.

### (II) The "decentralization-chaos-recentralization-being stifled" cycle

The adjustment endowed local governments with greater resources and autonomy. In addition, enterprises at various levels enjoyed greater independence. However, they were still the "workshops" directed by local governments under central planning. Although competition existed between local governments, such competition proved counter-productive as price mechanism, incentives and disincentives were not yet in place. As a result, this adjustment only paved the institutional and organizational ground for the "Great Leap Forward". On the other hand, the planned economy was dictated by a few political elites whose ideological, political and even emotional caprices could have a clear impact on the economy. China's economic course in this period was heavily influenced by the whims of political leaders.

The decentralized planned economic system, together with People's Communes, created the institutional foundation for the "Great Leap Forward". Responding to Mao Zedong's call to "surpass Britain in three years and America in ten years", all levels of governments were engaged in a massive campaign of capital construction, recruitment and asset seizure from farmers. The impossible mission to "double iron and steel output in one year" triggered a war for resources and the mayhem of "egalitarianism, grab and withdrawal of bank loans".

Chaos took its toll on the economy, but the damage was covered up by exciting figures on the book. Deception plagued China's leadership. On the brink of nationwide starvation, Mao Zedong was obsessed with the question of "what to do with surplus grain" and called for "fallow" and "eating to your heart's content". As a result, People's Communes opened free canteens where one could "take whatever one needs".

The consequences emerged at the end of 1958. Production declined, corporate losses mounted, daily consumer goods fell into undersupply, and the economy experienced many difficulties.

In the face of challenges of such severity, the CPC Central Committee vowed to "compress the space" and "rectify leftist tendencies" on various major occasions including the Zhengzhou Conference and Wuchang Politburo Conference in November 1958 and the Seventh Plenum of the 8th CPC Congress in April 1959.

From July to August 1959, the CPC Central Committee held the famous Lushan Conference as historians call it. During the conference, the incumbent Politburo member Peng Dehuai sharply criticized the Great Leap Forward and People's Communes. Peng Dehuai's change of political stance provoked Mao Zedong, who was still immersed in the country's rosy picture drawn by fake statistics.

Mao, in his wrath, started an "anti-rightist campaign" at the Lushan Conference, an event that was otherwise designed to correct leftist mistakes.

The second round of "communist sweep" as a result of the Lushan Conference aggrieved China's economic and social landscape. National grain output stood at 170 billion kilograms in 1959, down by 30 billion kilograms compared to the actual output of 200 billion kilograms in 1958. Grain output further dropped to 143. 5 billion in 1960, which is shamed even by the figure of 143. 7 kilograms nine years ago in 1951. The whole nation plunged into a massive famine.

Widespread malnutrition and dropsy in urban areas went unreported and thus unrelieved. In the countryside, this contributed to between 20 million to 40 million deaths.

In the autumn of 1960, the CPC Central Committee finally decided to restore the national economy. It reestablished the Financial and Economic Steering Group headed by Chen Yun to clear the economic turmoil caused by the "Great Leap Forward" and People's Communes. The central government took back the powers of fiscal, credit and corporate administration decentralized in the reform of 1958, putting into place a vertical leadership of financial, fiscal and statistical affairs. Enterprises entrusted to local governments in 1958 were mostly brought back under the administration of line departments at the central level. This highly centralized system was designed for resource redistribution: unproductive small smelting furnaces were closed, 30 million rural workers were asked to leave cities for the countryside, and industrial enterprises were either closed, stopped, merged or converted into other lines of production.

The economy began to stabilize after a few months of adjustment and was largely restored by 1964.

Drastic centralization again gave rise to the ills of the planned economy. Market-oriented reform, however, was politically unacceptable due to ideological barriers until the Cultural Revolution was called to an end in 1976. In this context, decentralization of planning power proved almost the only viable option of reform. Similar efforts were made several times following the decentralization reform of 1958, such as the economic restructuring of 1970.

In brief, the repeated decentralization efforts from 1958 to 1976 all ended in chaos and recentralization that stifled the economy.

### (III) Reflections

The vicious cycle described above prompted serious thinking and revealed the potential drawbacks of a planned economy based on public ownership.

Sun Yefang is the first economist to challenge the approach of "institutional decentralization". In a letter to China's economic leadership in 1961, he argued that economic administration is not all about division of power between central and local governments. Rather, "it is everything about the rights and responsibilities of enterprises as independent auditing entities, as well as their relationship with the government." According to Sun Yefang, "the only way to mobilize enterprises to take ownership" is to allow them to decide on their own matters and be responsible for the outcomes.

It was not until the mid-1980s that modern economic theory was used to analyze the pros and cons of "institutional decentralization".

In this hindsight argument, one view holds that "institutional decentralization" played a positive role in China's economy and particularly the non-state sector. Fiscal decentralization in the early 1980s, for instance, intensified regional competition that was essential to the emergence and development of privately run enterprises. Fiscal independence allowed local officials to provide local township enterprises with financing, production and sales priorities that fuelled the boom of China's non-state enterprises.

Another view argues that decentralization under a market economy, rather than a planned economy, is the only way to fundamentally improve the economy and efficiency.

According to the latter view, China's decentralization reform of 1958, 1970 and 1980 indeed made it possible for market relationships to grow from margins of regional competition. Yet it also spawned tendencies towards protectionism and market segregation. By the mid-1980s, regional blockage, market segregation and protectionism presented major barriers to an integrated market that China strived to build. Some even described China's economy as a "vassal state economy."

For China during the mid-1980s, when market forces were allowed to take root to a limited extent, breaking regional blockage and forming an integrated market were key priorities of reform efforts.

## II. Encouragement of the Non-state economy (1979 -1993)

Fruitless reform initiatives under the framework of a planned economy forced China to take stock. At this stage, a key priority was to allow attempts beyond the public ownership system. These attempts comprised positive elements of reform, opened space for the non-state economy, and paved the way for more systematic strategies of incremental reform.

### (I) Frustration of "intra-system reform"

The evident failure of the planned economy forced the central government to think about other ways beyond the institutional bonds that still persisted. But the question was how? Should China just modify the existing system by allowing enterprises to run by themselves or give full play to the market mechanism under some planning, or even alternatively establish a market economic system across the board?

At first, the conservative approach gained the upper hand both in debate and in practice. However, its intrinsic flaws quickly surfaced. Meanwhile, market-oriented reform including ownership reform were cautiously but proactively experimented among the public and showed great vitality.

Reform was officially launched by the Third Plenum of the 11th CPC Congress. Hu Yaobang, who was in charge of the Central Party School at that time, supported a commentator article *Practice is the Only Criterion for Testing the Truth* which appeared in the *Guangming Daily* on May 11, 1978. His vocal support sparked an enlightenment movement that put an end to a decades-long ideological tradition and inspired workers, farmers, intellectuals and cadres to open their minds to a possible course through which their country could not only survive but thrive. The Chinese government also sent delegations to learn from the United States, Western and Eastern Europe, and Eastern Asia.

It is in this context that reform was brought upon the agenda of decision-makers. The State Council Theoretical Meeting held from July to September 1978 dispensed documents explaining how countries like Yugoslavia and Romania achieved rapid economic growth by virtue of corporate reform and opening up to foreign capital. Then Vice Premier Li Xiannian wrapped up the Theoretical Meeting by stating that aside from productivity, the imperative also includes the mission to transform the superstructure, administration of industrial and agricultural enterprises, and the ways people work and think.

As for how to reform the economic system, two views prevailed:

One argued for the independence of state-owned enterprises (SOEs) as the main concern. During the political and economic "rectification" after the Cultural Revolution, most economists and politicians agreed with Sun Yefang's economic philosophy that the reform should concentrate on corporate autonomy and economic restructuring. As Li Xiannian wrapped up the Theoretical Meeting, "a major mistake of economic reform over the past 20 years is the preoccupation with administrative division and transfer that led to a vicious cycle of repeated decentralization and recentralization. Future reform, therefore, must give enterprises independent status, allowing them to proactively rather than passively follow economic accounting systems and improve overall economic efficiency."

Another view held that reform should aim to establish a brand-new economic system completely a different from the Soviet model: socialist commodity-based economy. According to the influential *Research Report on China's Socialist Economy* published in 1979 by Xue Muqiao, who was a senior economic scholar and had been in charge of China's economic leadership since 1949, China's economic reform must address two urgent issues: "First, reform of corporate administration (including collective economic entities) to make enterprises vibrant grassroots business entities; the second is the reform of national economic administration to meet the requirements for socialized mass productions."

The first view was more accepted among policy implementers and SOE leaders. Under the influence of this philosophy, Sichuan province took the lead in corporate reform. In October 1978, Sichuan conducted a pilot program on six state-owned factories with great successes. Later, the experiment was expanded to increase independence for 100 SOEs. In July 1979, the State Council issued a series of directives asking local authorities to experiment with greater corporate autonomy in line with state regulations. By the end of 1979, the number of industrial enterprises in the reform program increased to 4,200. By 1980, it increased further to 6,600. Their output value accounted for 60 percent of China's budgetary industrial output value and their profits accounted for 70 percent of aggregate profits of China's industrial enterprises.

China's reform of "expanding corporate autonomy" is similar to the Soviet reform of "complete economic accounting system" led by USSR Prime Minister Kosygin in 1965. It mainly includes two elements: streamline planning indicators and ease planning control; increase incentives to enterprises and their employees.

In the beginning few months, increased autonomy inspired great enthusiasm among corporate employees. However, similar practices of Kosygin reform turned out to have their own flaws. Independent enterprises were not governed by rules of fair competition or price information. As a result, one could see that their initiatives may not necessarily enhance resource allocation in a positive way. Under urgent calls for industrial development and heavy pressures of additional investments, aggregate demand had spun out of control, fiscal deficits ballooned, and the economy plunged into disarry.

### (II) Encouragement for non-public enterprises

Frustrated by the bottlenecks of intra-system reform, the central leadership demonstrated admirable tolerance and flexibility. Turning from tacit agreement to institutional acknowledgement, the central government took steps towards market-oriented reform outside public ownership system. Rural land reform based on the household contract responsibility system marked the first step of ownership reform that went from strength to strength outside the state sectors. Opening-up and domestic reform progressed hand in hand, and private ownership and the market-based pricing system gained de facto recognition. Non-public sectors and market pricing exerted a strong influence on public sectors and command pricing systems. But both of them ran parallel for a long period of time and developed into "double track" economic and price systems.

In September 1980, the CPC Central Committee decided to allow farmers to practice the household contract responsibility system on a voluntary basis. In just two years, this system replaced the "three-tiered ownership system based on teams" of People's Communes in most parts of China. This transformed the landscape of rural economy. Township enterprises based on collective ownership also prospered. From then on, China embarked on a new strategy different from countries of the former Soviet Union, which was to redirect reform to the non-public sectors where market-oriented enterprises are created to support economic growth, rather than focusing on state-owned sectors of the economy. This strategy can be described as "incremental reform" or "ultra-system" strategy.

After initial success in agriculture, this reform strategy was extended to other sectors of the economy. With the precondition of a dominant state economy, China gradually lifted restrictions on private business activities. Thriving private businesses, coupled with opening-up to foreign capital, had created a space for the development of private economy from the bottom up.

Strategies of non-public economy are exemplified as below:

First, to allow the growth of non-state enterprises: In 1983, China actually lifted the restriction on the recruitment by private business owners. This move acknowledged the legal status of private enterprises and ushered in a rapid development of the private sector.

Second, to create the "micro-climates" of "special economic zones," bringing certain regions in line with international markets: the Third Plenum of the 11th CPC Congress in December 1978 officially declared the principle of "opening-up" and proactive pursuit of economic cooperation with all countries on an equal and mutually beneficial footing. In 1979, the Chinese government adopted "special policies and flexible measures" for Guangdong and Fujian provinces to give play to their geological proximity to Hong Kong and Macau. In 1980, China established four special economic zones including Shenzhen, Zhuhai, Shantou and Xiamen. In 1985, China decided to open 14 port cities on the coast. Since reform and opening-up, China has continued to open up regions along its coastline, rivers and borders.

Third, to establish experimental zones of economic reform: After the State Council recognized four cities of "integrated economic reform," i. e. Guangzhou, Foshan, Jiangmen and Zhanjiang of Guangdong province in 1985, by the mid-1990s, China developed large regions of integrated market and economic vibrancy, which spanned from the East Shandong Peninsula to the coastline of Guangxi province. Some interior provinces also adopted such flexibility. The role of the market became increasingly influential in these pilot regions and beyond.

The most successful achievement of reform at this stage was the emergence of vibrant private economy. By the 1980s, China's private industries grew two times faster than did state-owned industries. By the mid-1980s, elements of the non-state economy gained a predominant position both in industrial production and the national economy as a whole. In industries, their output share increased to more than one third; in retail commerce, the non-state economy expanded its share even more rapidly.

Encouragement of private enterprises brought about rapid growth and innovation. Over 12 years from 1978 to 1990, China's annual GDP growth averaged 14. 6 percent, and urban per capita disposable income increased at a rate of 13. 1 percent per annum.

### (III) Formation of the "double-track system"

The non-public economy and the market pricing system inevitably ran counter to the state-owned economy and the command pricing system.

Since the inception of reform and opening-up in the late 1970s, state-owned enterprises were allowed to sell products at their own discretion. In 1979, the State Council issued a directive to allow enterprises to sell products regardless of state sales quotas. This explored a second track of goods distribution in addition to the planning system: the market track.

Meanwhile, burgeoning non-state enterprises also demanded the acquisition of raw materials from the market since they had no access to the state material distribution quotas. By the mid-1980s, the industrial aggregate output value of non-state enterprises accounted for 31 percent of the national total. An increasing proportion of goods and materials were distributed through the market system. In this context, the State Price Bureau and State Materials Bureau issued a directive in January 1985 to allow enterprises to sell and purchase "ultra-planned" products at market prices. This officially launched the "double-track system" of material supply and pricing. State-owned enterprises that had access to material distribution quotas before 1983 could still access materials of the base quantity of 1983 at quota prices. As for excess demands beyond the base quantity, these enterprises had to purchase from the market at market prices.

The coexistence of the state sector and private sector gave rise to various forms of "double-track systems," including double-track prices, double-track interest rates and double-track foreign exchange rates, just to name a few.

Economists hold different views as to the pros and cons of double-track systems.

Liu Zunyi, Qian Yinyi and Gérard Roland have made positive comments on the role of double-track prices in stabilizing state economy and achieving Pareto improvement. Using general equilibrium analysis they examined the characteristics of Pareto improvement resulting from double-track price liberalization.

U. S. economists Kevin Morphy, Andrei Shleifer and Robert Vishny disagreed. They think that desynchronized price liberalization had distorted resource allocation. Moreover, this would create inequality between indirectly subsidized state-owned enterprises and their private counterparts to which raw materials, equipment and loans were supplied at market prices. Such inequality, they argue, increasingly blocked further growth of the private economy.

In the view of some Chinese researchers, myself included, the socioeconomic consequences of "double-track system" are twofold. On the positive side, it allowed certain space for private initiatives, allowing various kinds of private enterprises to grow and prosper. However, if China persisted with, or even strengthened, such an institutional arrangement where state power can be translated into money or capital acquisition, it will create an environment of rampant rent-seeking that breeds corruption. Additional steps toward market-oriented reform are essential to address this problem. Otherwise, privileged capitalism will take hold with serious economic, social and political consequences.

## III. Full-scale reform (1994 – present)

The very reference to the "double-track system" means that China's economy still had numerous elements of the inefficient state-economy and non-market price system. The State economy and planned system collided with growing non-public economy and market-based system. Full-scale reform was launched to achieve major breakthroughs. China took bold measures to integrate the "double-track" price system and overhauled state-owned enterprises. Many of these measures proved effective and made critical contributions to the rapid and sustained development of China's economy. Due to a number of factors, however, many critical reform initiatives failed to advance as planned, making their implementation even more difficult in the future.

### (I) Experiment with full-scale reform

This is another brand-new chapter of China's reform. Reform shifted back from the non-state sector to state sector, from the countryside to cities, from price system reform to the integrated reform of price, tax and fiscal systems, and from economic to political reform. These reform initiatives made major progress in several areas, especially in the establishment of a macroeconomic system and ownership restructuring. Unfortunately, disrupted by unexpected incidents and undermined by vested interests as it was, China encountered major setbacks in both economic and political reforms and failed to achieve the desired results. This failure made future reform all the more difficult.

As an advocate of "incremental reform" beyond the state sector, Deng Xiaoping was unsatisfied with the preliminary achievements in the non-state sector. When the non-state sector had grown strong enough to be dependable as a pillar for the overall reform, he called for a shift of reform to focus on the state sector. He pointed out in June 1984 that when rural reform showed success, "reform should shift from the countryside to cities. Urban reform should include not only industry and commerce, but all sectors of technology research and education as well." The Third Plenum of the 12th CPC Congress held in October the same year made a decision to carry out this strategic repositioning.

A string of reform initiatives were adopted starting in 1986. In early 1986, the then Chinese premier Zhao Ziyang envisioned an integrated reform approach with priorities on price, tax and fiscal systems. In April 1986, the State Council established an economic reform office to develop a reform package of price, tax, fiscal, financial and trade systems. Price reform was intended to follow the practice of Czechoslovakia from 1967 to 1968, i. e. to adjust prices across the board based on calculation results, and then to lift all price controls in one or two years for price integration. On the fiscal reform front, China transformed the revenue-sharing system, which was then in place, into a tax-sharing system and introduced VAT.

Meanwhile, Deng Xiaoping once again called for the distinction between political parties and the government with the intention of adapting China's political system to the newly established market economy. "Without political reform, results of economic reform cannot be guaranteed; without economic reform, development of productive forces will be obstructed, and so will the success of our modernization drive." Regretfully, both of these reforms were discontinued.

In October 1986, the State Council leadership changed their mindset to focus on the reform of state-owned enterprises. In 1987 and 1988, lump-sum contracting systems were adopted for the operations of state-owned enterprises, departments, public finance, foreign trade, and credit financing. This meant returning to the coexistence of the double-track market economy and command economy. The opportunity for full-scale reform was lost. Corruption and inflation became unstoppable, ending in the purchase stampede of 1988 and the political turmoil of 1989.

After the economic crisis of 1988 and the political turbulence of 1989, some politicians and theoreticians blamed all the faults on market-oriented reform. "Phasing out the planned economy for the market economy," they argued, "is tantamount to altering socialism for capitalism." Efforts at reform and opening-up were stalled once again. It was not until early 1992 when Deng Xiaoping made pro-reform speeches during his tour to south China that enthusiasm for reform and opening-up was rekindled.

The 14th CPC Congress held in October 1992 adopted the reform objective to establish a socialist market economy. The Third Plenum of 14th CPC Congress held in November 1993 adopted important resolutions on socialist market economy: First, to advance the new strategy to "advance reform on all fronts with the key priorities". Reform was officially targeted at the state-owned sector and aimed to phase in socialist market economic system by the end of the 20th century. Second, the meeting defined targets and developed plans for reform priorities on fiscal, financial, foreign exchange, corporate and social security systems.

Following these *Resolutions*, the Chinese government took a series of major steps to advance reform in the above-mentioned systems and state-owned enterprises. Meanwhile, the State Council called for experiments with modern corporate system according to the *Corporate Law* in order to roll out successful experiences afterwards. Of all of these, foreign exchange reform proved the most successful and achieved ahead of schedule the target of a "managed floating foreign exchange rate regime" under the current account. Fiscal system also entered its predefined course. On other fronts, particularly in the reform of the state economy, certain progress was made but was still not up to the standards of a modern market economy.

By the mid-1990s, China achieved major progress both in the establishment of a macroeconomic system and ownership restructuring. The state sector no longer dominated China's economy and declined substantially in proportion to the private sector. Even so, China was still awaiting a breakthrough in the establishment of an ownership system designed for market-based economy. By 1993, the share of the state economy in GDP was reduced to less than half, but government and state-owned enterprises were still in control of scarce economic resources. More than 70 percent of credit financing, for example, was allocated to the state sector. Dominance of government and state-owned enterprises stood in the way of improvement in financial and fiscal systems underpinning the market economy. At a fundamental level, the state economy comprised the core and laid the foundation for the entire old system. This structure is described as "the state syndicate" by Lenin in *Nation and Revolution*, or "the Party-State Inc." in our contemporary language. Interest groups based on this structure were complex and intertwined. Unless it took into account the broader demands, vested interests of the old system would obstruct the reform and reorganization of the state sector in various names including political excuses. That would constitute the major obstacles to reform and restructuring of the Chinese economy during this period.

### (II) Reform and contradictions at the turn of the century

As reform evolved and expanded in scope, the conflict between pro-reform and anti-reform forces intensified. Initially, the resistance was ideological, but at this point, it came mainly from vested interests. Measures taken at the inception of reform had the making of a Pareto improvement, while at this point, state-owned monopolistic enterprises and government agencies already shared in the results of reform. Further reform, however, would damage their interests. Further reform of state-owned monopolistic enterprises and political system hinges upon changes to be taking place within government. This marks a new phase of reform, which is more difficult and much slower.

The Fifteenth CPC Congress of 1997 took decisive steps to remove barriers of the old ownership system. It rejected the notion that the share of the state economy is a sign of socialist nature, and explicitly reaffirmed that diversified ownership will remain a "basic economic system" of socialism at the preliminary stage for one hundred years to come.

In 1998, these decisions were written into *Amendment to the Constitution of the People's Republic of China*: "At the preliminary stage of socialism, China adheres to the basic economic system with public ownership at the backbone and joint development of all types of ownership." "Non-public elements such as an individual economy and privately run economy are essential components of a socialist market economy." "The government protects the legitimate rights and interests of the individual economy and privately run economy."

The following years saw remarkable headway in China's economic reform.

First, the ownership structure of national economy improved. Dominance of the state economy gave way to a diversified ownership structure. Except for a few monopolistic industries, private economy normally holds sway. Private enterprises are the biggest source of jobs as well. In 2006, 72 percent of urban jobs in China came from private enterprises.

Second, reform of state-owned enterprises broke new ground. State-owned enterprises became corporations with a diversified shareholding portfolio, as opposed to the previous arrangement where the state was the sole investor. For non-financial enterprises, most state-owned grade-II enterprises have been turned into corporations with relative or absolute state controlling share. For financial enterprises, four state-owned commercial banks have been wholly listed overseas at the dawn of the 21st century, providing a necessary micro-base for China's financial market. Second, with a diversified shareholding structure, these corporations put into place the basic framework of corporate governance structure.

Despite the establishment of a basic framework for the market economic system at the end of the 20th century, China still needed to put into place important elements such as a well-functioning financial market and the rule of law that is essential to any modern market economy. Given these deficiencies, the Third Plenum of the 16th CPC Congress adopted Decisions on the Improvement of Socialist Market Economy. However, implementation of these decisions was not free from resistance and barriers. As reform slowed, new developments occurred reflecting apparent social contradictions.

First, restructuring of the state economy and corporatization of state-owned enterprises all made key progress according to the directives of the Fifteenth CPC Congress and its fourth plenum. At the dawn of the 21st century, small and medium-sized state-owned enterprises including township enterprises affiliated to grassroots levels of government all completed reforms, with most of them turning into individual solely-funded enterprises or corporations. Reform obviously slowed when it reached state-owned monopolistic enterprises in key industries such as energy, telecom, petroleum and finance.

Recent years have seen a rekindling of the debate as to whether state-owned enterprises should advance in, or withdraw from, key industries. Some commentators hold that the share of the state economy should be increased rather than reduced. In 2003, some officials with the State Assets Supervision and Administration Commission (SASAC) propagated the view that the "state economy is the economic foundation for the governance of the Communist Party of China". This statement caused significant ideological chaos at that time. Despite clarifications by officials of the CPC and the government at the central economic working conference of 2004, similar arguments still sold well among some people. Since the debate on the correctness of market-oriented reform in 2004, the phenomenon of "re-nationalization" or "neo-nationalization" emerged. This tendency finds expression in two forms: First, after granting private enterprises with access permits, the government backtracked to prevent their continued operation. Second, some solely state-funded and state controlled corporations launched a campaign of mergers and acquisitions of private small and medium-sized enterprises to consolidate their monopolies.