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The Institutional Foundations of China's Market Transition

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Abstract

This paper intends to properly account for China's two decades of market transition by examining its institutional foundations. The journey of transition is analyzed as a two-stage process. In the first stage (1978-93), the system was reformed to unleash the standard forces of incentives, hard budget constraints, and competition, but the underlying institutional forms and mechanisms are far from conventional: reforming government through regional decentralization; entry and expansion of nonstate (mostly local government) enterprises; financial stability through "financial dualism;" and a dual-track approach to market liberalization. In the second stage, China aimed to build a rule-based market system incorporating international best practice institutions but proceeded in its own way. Major progress was made in the first five years (1994-98) on the unification of exchange rates and convertability of the current account; the overhaul of the tax and fiscal systems; reorganization of the central bank; downsizing of the government bureaucracy; and privatization and restructuring of state-owned enterprises. To complete its transition to markets, China still faces serious challenges, especially in transforming its financial system and state-owned enterprises and in establishing the rule of law.

The paper concludes by reflecting on the economics of reform and institutional change from the Chinese experience. The main lesson learned is that considerable growth is possible with sensible but not perfect institutions, and that some unconventional "transitional institutions" can be more effective than the best practice institutions for a period of time because of the second-best principle. Specific lessons include: incentives, hard budget constraints, and competition should apply not only to firms but also to governments; reforms can be implemented without creating many or big losers; and successful reforms require appropriate, but not necessarily optimal, sequencing.

The Institutional Foundations of China's Market Transition

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1. Interpreting China's Transition to Markets: The Institutional Perspective

In the two decades between 1978 and 1998, China has transformed itself from a centrally planned economy to an emerging market economy and at the same time has achieved nearly a 10 percent average growth rate. During this period, China's per capita GDP has more than quadrupled and the living standard of ordinary Chinese people has improved significantly. For instance, per capita consumption has increased four times for eggs and eight times for poultry, the per person living space has more than doubled in the urban areas and nearly tripled in the rural areas, and total household bank deposits, measured against the GDP, increased from less than 6 percent in 1978 to more than 60 percent in 1998. The benefits of the reform were also shared by the people on a broad basis. The number of people living in absolute poverty has been substantially reduced from over 250 million to about 50 million in two decades, a decline from one-third to a twenty-fifth of China's population. Life expectancy on the other hand has increased from 64.37 in the 1970s to 70.80 in 1996 (68.71 for men and 73.04 for women), with infant mortality falling from over 50 per thousand in the 1970s to less than 30 per thousand in the 1990s (*China Statistical Yearbook*, 1997; *Almanac of China's Population*, 1997). In 1998, the World Bank moved China's ranking up from a low-income to a lower-middle-income country.[1]

Such a performance appears more impressive when compared with the average performance of the transition economies in Eastern Europe and the former Soviet Union. By 1998, with only a few exceptions, the great majority of these countries still have not recovered to their 1989 output levels according to the official statistics. The Chinese performance looks even more impressive when considering the fact that transforming large countries is much more complicated than transforming smaller ones; conceivably, the tasks of transforming Russia or China are more challenging than those of transforming Poland or Vietnam. At the outset, China's reform went against all odds: Coming out of the disastrous decade of the Cultural Revolution, it was poor, over-populated, lacked human capital and natural resources, and was constrained by adverse

[1] Centrally planned economies also had a high growth period (such as the Soviet Union in the 1930s and 1950s, Eastern European countries in the 1950s and 1960s, and China in the 1950s). However, it is well known that such a growth rate was based on heavy industry expansion at the sacrifice of consumer industry and thus the people's living standards, and it was always associated with chronic shortages (Kornai, 1980). China's high growth in the past two decades was different: consumer and export industries boomed, the people's living standards improved, and chronic shortages disappeared.

ideology and political opposition. Two decades ago few economists would have bet on today's outcome of reform in China.

Even so, China's reform experience has been always viewed as an anomaly in terms of transition to a market economy, and it has not been properly accounted for by mainstream economics and thus appreciated by mainstream economists. For example, *From Plan to Market: World Development Report 1996* on transition economies (World Bank, 1996) gave China short shrift because it couldn't figure out where to put China on the various measurement parameters, and instead illustrated the Chinese experience mainly in boxes rather than in the text. China simply does not fit the general description of the report. However, the data point of China is too important to ignore: It has been one of the most successful transition economies, it produced more than all other transition economies combined in 1998 in terms of GDP, and, moreover, its per capita GDP is very likely to surpass that of the 15 former Soviet Union countries in the next decade, which was unthinkable a decade ago.[2]

Still, economists tend to underestimate the significance of China's reform experience. The most popular argument is that China was a poor agricultural country and thus reform was easy. Of course China was much less developed than Eastern Europe and the former Soviet Union at the outset of reform and the latter faced some difficulties that China did not have, such as problems of excess industrial capacity and comprehensive welfare coverage. However, this argument does not explain how and why China's reform was successful, especially considering that it faced double difficulties: As a planned economy, China faced many problems similar, although not identical, to Eastern Europe and the former Soviet Union, such as a lack of property rights and markets, persistence of a predatory government, and the difficulty of maintaining financial stability. In addition, as an underdeveloped country, China also faced many problems that do not exist in Eastern Europe and the former Soviet Union, such as enormous population pressure, severe shortages of human capital and natural resources, very poor industrial and infrastructure bases, and a lack of democracy. The fact that China faced the double problem of transition and development presented a bigger challenge and it is far

[2] According to Maddison's (1998) calculation based on purchasing power parity, without taking into account the 1998 Russian economic crisis, China's per capita GDP will surpass that of the 15 former Soviet Union countries by 2010.

from clear how China managed to succeed. After all, there are many poor countries that do not grow.

The reasons why China's reforms are not properly understood and thus appreciated by mainstream economists are profound. There are strong prior beliefs, based on the existing knowledge of economics, about the formulation that a transition should use. Furthermore, such beliefs are supported by the strong evidence from the failed economic reform in Eastern Europe and the former Soviet Union prior to 1990 which did not follow that formulation. The theory and evidence together formed a powerful "conventional wisdom" about a set of necessary and sufficient conditions for a successful transition, that is, stabilization, liberalization, privatization, and democratization. Leaving aside the issue of whether they are sufficient to the experts on Eastern Europe and the former Soviet Union, the Chinese path of reform and its associated rapid growth seemed to defy the necessity part of the conventional wisdom: Although China has adopted many of the policies advocated by economists, such as being open to trade and foreign investment and macroeconomic stability, violations of the standard policy prescriptions are also striking. For most of the past two decades, China's reform succeeded without complete market liberalization, without privatization and secure private property rights, and without democracy. One might have thought that in the absence of these "essential" factors reform would fail.

Why has China grown so fast when conditions thought to be necessary for growth were absent? asked Blanchard and Fischer (1993). One might have reasoned that coexistence of the planning mechanism with partial liberalization would only cause more distortion and be a source of disruption, not growth. Without privatization and secure private property rights, one might conclude that there could not be genuine market incentives. Without democracy, economic reform lacks a political basis and commitment to a market and thus is vulnerable. The frustration and failure of reforms in Hungary, Poland, and the Soviet Union prior to 1990 only reinforced these views.

The actual performance of the Chinese reform provides a striking contrast to these expectations. Although China's market system remains highly imperfect even after two decades of reform, looking for a system like that which exists in the developed West has often confused the analyses on transition. China still needs a decade, probably more, to complete its transition to markets. Yet governments are not completely

unconstrained; property rights are not completely insecure; and markets are not as restricted as many would think. A basic fact of transition economies is that the starting point of reform is the planning system which was extremely inefficient because of allocative distortions and, more significantly, perverse incentives. Consequently, the economies operated not only far away from the Pareto frontier (and along the production possibility frontier) because of the enormous allocative distortions, but also deep inside the production possibility set because of poor incentives. There was a lot of room for efficiency improvement.

However, as the failure of Eastern European reform prior to 1989 attested, it is not easy to translate such an opportunity into sustained growth. Therefore, one needs to carefully examine what has changed. One big change was opening up the Chinese economy to the outside world. However, for a large country like China, foreign trade and investment per se are unlikely to be quantitatively as important as for small countries. The more important contributions of openness are the new ideas and technology and increased competition, but their effects ultimately depend on internal changes, which will be the focal point of my analysis.

In this paper I demonstrate that for the past two decades China has been undergoing highly dynamic, profound, yet smooth, internal institutional changes. I argue that these changes unleashed the standard forces of incentives, hard budget constraints, and competition for growth, but the path of transition China took was unusual and many of its underlying institutional forms and mechanisms were far from conventional. By using the analytical tools of mainstream economics and stretching the existing theories to consider the institutional features of the transition, I can better account for the Chinese reform experience. This approach allows us not only to explain the successful aspects of China's reform, but also to pinpoint the problems it generated and thus the challenges that lie ahead. In doing so, I hope to improve our understanding of China's reform and, at the same time, to develop a new paradigm for the study of reform and institutional changes in general.

I analyze the journey of China's transition to markets as a two-stage process, using Kornai's (1992) framework for analyzing system changes in socialist countries. In Section 2, I consider the first stage, corresponding to the first fifteen years between 1979 and 1993. In this stage, the old system was reformed to improve incentives, harden budget constraints, and create competition. I analyze four institutional pillars: regional decentralization of government, entry and expansion of nonstate (mostly local government) enterprises,

financial stability through financial dualism, and a dual-track approach to market liberalization. Each of them played a crucial role in moving China away from the planning system and at the same time contributing to economic growth, but none are conventional or were recommended by economists at the outset of reform.

In Section 3, I examine the second stage. Since 1994, China has set a goal of establishing a rule-based market system as well as privatization and restructuring of state-owned enterprises. China appears to be the first and only country under Communist Party to made such a dramatic ideological shift and it occurred without a political revolution. In the first five years between 1994 and 1998, China unified the foreign exchange market and made its current account convertible; overhauled the tax and fiscal systems according to international practice; centralized the central bank operation, downsized its government bureaucracy and forced the military to give up their commercial operations, and started to privatize state-owned enterprises and lay off their workers. Both the ideological shift and the significant progress made so far have demonstrated that China's early reform built constituencies and momentum for further reform, rather than created obstacles to block it. The political economy of reform and the dynamics of transition in China followed a pattern which is also hardly conventional.

To complete its market transition, China will still face many serious challenges. In section 4, I highlight the three most important ones: transforming the financial system, restructuring state-owned enterprises and corporate governance, and establishing the rule of law. I will examine the major difficulties involved in further reforms, outline the required deeper institutional changes, suggest some ways to achieve them, and propose future research topics. The study on these three areas should be the priority on the research agenda for China to successfully complete its transition to markets. Although there is no guarantee that China can achieve that, evidence suggests that it has a good chance.

In section 5, I reflect on the economics of reform and institutional changes from the Chinese experience. In Eastern Europe, reforms started as early as 1968 in Hungary, 1980 in Poland, and 1985 in the Soviet Union. China, Hungary, Poland, and the Soviet Union went through a similar two-stage process: first reforming the planned system and then replacing it with a market system. The big difference is that in Eastern Europe, piecemeal reform in the first stage failed, and the second stage was jump-started in a revolutionary

manner. In contrast, in China the first stage was remarkably successful, which allowed the second stage to be built upon its momentum without a political revolution. China's first stage of reform was much more radical than that in Eastern Europe, its second stage less so, and overall it has been a smoother process. While the Chinese experience of transition in no way violates economic laws and is unlikely to provide a model for Eastern Europe, it does challenge the conventional wisdom on system changes and shows that some planned economies can be reformed; such a reform can be deepened into a full scale transition to market without a political revolution; and there may well be diverse paths of successful transition to markets.

It is easy to criticize China's reform in specific areas as well as in overall sequencing, and also possible to show that even better results could have been achieved if some alternative strategies had been followed. However, because to many economists surprise, China's reform has been an overall success in spite of many obvious problems, it needs first to be understood from a positive rather than normative perspective. In this view, the main lesson from the Chinese experience is that considerable growth is possible with sensible but not perfect institutions, and that some "transitional institutions" can be more effective than the best practice institutions for a period of time because of the second-best principle: removing one distortion may be counter-productive in the presence of another distortion. Specific lessons include: incentives, hard budget constraints, and competition should not only be applied to firms but also to governments; reforms can be implemented without creating many or big losers; and, successful reforms require appropriate, not necessarily optimal, sequencing. Studying China's experience should augment our knowledge about reform and institutional changes in general, and transition to markets in particular.

2. Reforming the System: 1979-93

The historic decision on "reform and opening up" made at the Third Plenum of the Eleventh Congress of the Chinese Communist Party on December 18-22, 1978, marked the beginning of China's reform era. At the time China had a clear desire to increase productivity and raise living standards by reforming its economic system and structure, but it did not have a clear objective of what the new system would be like and thus proceeded with the reform as though "crossing the river by touching stones." In the first fifteen years, China

did not establish uniform rules or international best practice institutions as we know them; nevertheless, it underwent dynamic and fundamental institutional changes. Below I describe the four pillars of this institutional change for reforming the government, firms, the financial system, and markets respectively. I will argue that these changes have unleashed the standard forces for growth: positive incentives, hard budget constraints, and competition, but in novel ways.

A. Regional Decentralization of the Government

The first pillar of institutional change comes from an unlikely source (in an economist's view): regional decentralization of the government. Although China *de jure* is a unitary state, it functions *de facto* in many ways like a federalist state. Its decentralized government has been called Federalism, Chinese Style (Montinola, Qian, Weingast, 1995; Jin, Qian, and Weingast, 1999).

As early as 1979, China started to devolve government authority from central to local levels, the latter including provinces, prefectures, counties, townships, and villages (municipalities being one of the first three). Local governments supervised about three quarters of the state industrial firms in terms of output and also had major responsibility for state fixed investments, initially in industry but increasingly in the infrastructure. Local governments at the township and village levels directly controlled township-village enterprises (TVEs). As a regulator of the local economy, local governments issued business licenses, coordinated local business development, resolved business disputes, and engaged in tax policies. Local governments also acquired the authority to determine the structure of local expenditure, and they were responsible for local public goods provision, such as schools, health care, utilities, price subsidies, urban development, etc. In particular, local governments played an important role in attracting foreign investment into their localities.

The first generation theories of federalism focus on the information advantage of decentralization (Hayek, 1945). They argue that local governments are in a better position to provide local public goods than the national government because they have access to better local information, or because inter-jurisdictional competition provides a sorting mechanism to better suit consumers' preferences (Tiebout 1956). Decentralization also allows for "laboratory federalism" under which some localities can carry out diverse

policies (Oates, 1972).

One notable feature of China's reform approach has been regional experimentation, which is possible because of regional decentralization (Qian and Xu, 1993; Qian, Roland, and Xu, 1999). Experimentation is useful because reform is a highly uncertain event and our knowledge about it is very limited. Reform cannot have a well-articulated blueprint, and even if such a blueprint existed, its implementation might still pose many problems. In the presence of high uncertainty, experimentation is a way to minimize costs through structured learning. One example is the successful agricultural reform. The household responsibility system in rural areas was developed through the initiatives of local governments. In 1978 when the rest of the Chinese rural areas were operating under the collective farming system, in Fengyang County of Anhui Province, several households in a village began to contract with the local government for delivering a fixed quota of grain in exchange for farming on a household basis. The practice was imitated by other counties in the province and promoted by the provincial government before it was promoted by the central government. By 1984, almost all farm households across China had adopted this method. Another example concerns famous special economic zones. In 1980, China established four such zones in Shenzhen, Zhuhai, Shantou, and Xiamen to allow foreign investments and market mechanisms to work when the rest of China was still under central planning. Later, many successful practices experimented with inside these zones, such as new accounting methods, employment practices, and marketing techniques, were adopted elsewhere.

The second generation theories of federalism extend the traditional approaches by systematically studying the role of government incentives in economic performance (Qian and Weingast, 1997). Because governments in developing and transition economies have often been the central barriers to economic development, providing these governments with the incentives to promote markets is especially critical. Specifically, the "market-preserving federalism" theory (e.g., Weingast, 1995; Montinola, Qian, and Weingast, 1995) argues that by devolving regulatory authority from the central to local governments, the interventionist role of the central government can be limited. The theory provides two possible mechanisms for aligning local governments' interests with promoting markets. One is through inter-jurisdictional competition under factor and goods mobility to discipline interventionist local governments. Another is through linking local government

expenditure with the revenue generated to ensure that the local governments face the financial consequences of their decisions.

The devolution of authority in China was also accompanied by the provision of fiscal incentives and local governments were encouraged and rewarded by promoting the economic development of their local economies. For the formal budgetary revenue starting in 1980, the "fiscal contracting system" (*caizheng chengbao zhi*) known by the nickname of "eating from separate kitchens" (*fenzao chifan*), replaced the previous system of "unified revenue collection and unified spending" (*tongshou tongzhi*), known as "eating from one big pot" (*chi daguofan*). Under the new fiscal system local governments entered into long-term (usually five-year) fiscal contracts with higher level governments, and many were allowed to retain 100 percent at the margin to make them "residual claimants." In addition, local governments also received "extra-budgetary funds," which were not subject to sharing, and "off budget funds," which were not even incorporated into the budgetary process and thus not recorded.

Using provincial panel data between 1982 and 1992, Jin, Qian, and Weingast (1999) reported three major findings about the role of decentralization and fiscal incentives in the central-provincial relationship. First, they found a very strong correlation between marginal budgetary revenue collection and marginal budgetary expenditure under the fiscal contracting system, as compared with a very weak correlation in the 1970s, 0.75 vs. 0.18. Thus, China's fiscal contracting system provided local governments with strong (marginal) fiscal incentives. Second, even so, they found some evidence that horizontal distribution in per capita budgetary spending actually improved over time, the coefficient of variation falling from 0.68 in 1982 to 0.52 in 1992. This is because strong marginal incentives were provided together with the infra-marginal redistribution of budgetary revenue. Third, they also found that stronger fiscal incentives, measured in terms of a higher contractual marginal revenue retention rate, were associated with faster development of non-state enterprises and more reform in state-owned enterprises (such as a faster increase of the share of contract workers in total state employment). These results were compared with Russia's. Using the data of 35 cities for 1992-1997, Zhuravskaya (1998) regressed the change in "shared revenues" (with the upper level government) on change in "own revenue," and found the coefficient was -0.90, which means that any increase

in a city's budget by 1 ruble is offset by the decrease in shared revenues by 0.90 ruble. She also relates the perverse incentives of local governments to their predatory behavior towards private businesses. It is this "grabbing hands" of local governments that were regarded as a major cause of the failure of Russian reform (Shleifer, 1997; Frye and Shleifer 1997).

Interestingly, China's regional decentralization and the fiscal contracting system have often been criticized by economists. The conventional view holds that economic reform means liberalization of markets and autonomy of enterprises and households, not decentralization within the government organization. Especially, many Chinese economists considered regional decentralization to be the wrong direction for reform because it looked similar to "administrative decentralization" under Mao Zedong. China's fiscal decentralization emphasizing local revenue self-sufficiency was seen as highly problematic and dysfunctional by public finance experts, who believed that it distorted resource allocation, generated regional inequality, and undermined the central government's fiscal policy (Wong, 1991). While some of the criticisms are valid, they failed to recognize the more significant positive contributions of regional decentralization on economic reform because they largely ignored the need for regional experimentation, and more importantly, the importance of the governments' incentives.

B. Entry and Expansion of Non-State (Mostly Local Government) Firms

It is well known that agricultural reform was the first reform success in China. But a bigger achievement lies elsewhere; in fact, most growth came from the non-agricultural sector, especially the industrial sector. In 1998, the agricultural share of China's GDP was 16 percent, about the same level as in Poland and the Soviet Union in the 1980s. The second pillar of institutional change concerns the innovative ownership forms of non-agricultural firms.

The Chinese economy is divided into "urban" and "rural" areas, which is an administrative rather than an economic concept. Firms in the urban area consist of state-owned enterprises (SOEs), collective enterprises, private firms, and other types of firms which include foreign firms, joint ventures, stock companies, etc. Firms in the rural area consist of two ownership types: township and village enterprises (TVEs) which are community

public firms, and private firms. In China, the state sector refers to SOEs in the urban area and the non-state sector refers to the rest.

Evaluation of SOE reform has generated heated debates,[3] but all agree that the engine of growth in China came not from state enterprises, but non-state enterprises. Between 1978 and 1993 the share of non-state enterprises increased from 22 percent to 57 percent, which happened without any privatization of SOEs and was entirely the result of fast entry and expansion of new non-state enterprises. Therefore, the growth of the non-state sector is the key to a better understanding of China's reform (Qian and Xu, 1993).

Thus, China shares common ground with post-1990 Eastern Europe and Russia in that new entry firms, rather than old state firms or even privatized firms, are the driving force of growth. But China differs from the latter in an important aspect: between 1979 and 1993, most of the new Chinese firms are not private firms, but local government firms. Private enterprises played only a minor role; in 1993 they contributed to less than 15 percent of the national industrial output. The most important part of local government firms are TVEs, which numbered 1.5 million with employment of 52 million in 1993. The shares of TVE output and employment in rural industry were 72 percent and 58 percent respectively (*China Township Enterprises Statistical Yearbook*, 1994). The TVEs are significant by both absolute and relative measures. This is the single most important factor that makes China's reform fundamentally different from that of Hungary or Poland before 1990, where enterprise development outside the state sector was small and restricted to services.

The rise of TVEs has been unexpected, even by the Chinese reformers themselves.[4] Like regional decentralization, TVEs and the associated "local industrialization" have been frequently criticized by economists, and in this case, from both conservative and liberal camps simply because TVEs do not fit either the central planning or market models. TVEs were criticized as disrupting the state sector on the one hand, and having too much local government intervention on the other, and both sides see them as inefficiently run.

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[3] Jefferson and Rawski (1994), Groves et. al. (1994), and Li (1997) found significant positive productivity growth, which is attributed to better incentives by Groves et. al. and to increased competition by Li respectively. On the other hand, Woo et. al. (1994) found little productivity growth. I will discuss SOE reform in sections 3 and 4.

[4] Deng Xiaoping said on June 12, 1987: "The greatest achievement that was totally out of our expectation is that rural enterprises [TVEs and private enterprises] have developed" (*Economic Daily*, June 13, 1993).

China's reform performance would look very different without TVEs, and therefore it is not possible to understand industrial reform in China without appropriately accounting for them (Weitzman and Xu, 1994). The crucial feature of TVEs is the community (i.e., township or village) government control of firms, in contrast with private or central government control. But the comparative advantages of community government ownership of firms over private ownership is far from clear, given the obvious costs associated with government intervention. New theories, three of which I highlight, have been developed by considering the imperfections of the institutional environment in China of insecure property rights and imperfect capital markets respectively, as well as the particular features of the fiscal system.

The community government plays a critical role in protecting TVEs in an environment lacking secure property rights (Chang and Wang, 1994; Li, 1996). Without a rule of law and with strong anti-private property ideology, private enterprises in China were often attacked, for example, during the "anti-spiritual pollution campaign" of 1983, the "anti-bourgeois liberalization campaign" of 1987, and after the Tiananmen incident of 1989. But the property rights of local government-owned firms (such as TVEs) are more secure in this institutional environment. Che and Qian (1998b) developed a theory of local government ownership based on incomplete contracting (Hart, 1996). They argue that the community governments' feature of engaging in both the government activity of providing local public goods and the business activity of controlling TVEs, which is usually considered negative, has an advantage under insecure property rights. This is because community government is more likely to invest revenue in local public goods than private entrepreneurs would be, which in turn will benefit the higher levels of government in the future. Knowing this, the higher government rationally preys less on TVEs than on private enterprises and the TVEs are less worried about revenue confiscation. In fact, TVE after-tax profits were mostly used for two purposes: reinvestment and provision of local public goods. For example, in 1992, 59 percent of the after-tax profits of TVEs were reinvested and 40 percent were used for local public expenditure (*A Statistical Survey of China*, 1993). Hence, local government control over firms can not only benefit governments, but also be efficiency improving on the grounds of more secure property rights and more local public goods investment.

In transition and developing economies, capital is one of the most scarce resources, and new entry firms

have great difficulty obtaining it. TVEs, with community government control, have several advantages in financing investment compared to private enterprises. The community government can make use of its political connections with the state banks to channel loans to TVEs, and the state banks are also more willing to lend to TVEs because discrimination against private enterprises makes lending to the latter politically more risky. On economic grounds, the community government is able to reduce the risks borne by the banks through cross-subsidization among its many diversified enterprises (Byrd, 1990), or it can use accumulated collective assets as collateral or as co-investment funds to reduce potential hazards in the lending-borrowing relationship (Che and Qian, 1998a). Also, the community government can reduce information asymmetry involved in market transactions by integrating a number of investments, since market observations drawn from these transaction are much more informative than they are when drawn from transactions resulting from unorganized private investments (Che, 1998).

Insecure property rights and imperfect capital markets are also the common features of other transition and developing economies but why don't we see TVEs or similar types of firms elsewhere more often? The regional decentralization in China described above appears to have played a central role, because local governments at township and village levels are empowered with comprehensive authority for local economic development, and they are also provided with the incentives to do so since they can keep the revenues generated (Byrd and Gelb, 1990; Oi, 1992). Elsewhere, the tasks of government bureaucrats are simply collecting taxes and passing them up to the higher level governments. But a deeper question is: why can't the local government get more revenue by taxing private firms than by developing their own firms? Che and Qian (1998b), using the incomplete contracting framework, argue that ownership rights give the government control over the firms' financial accounts and thus make it less costly to extract revenues from them than taxing private firms. For the same reason, when local governments control firms, it is also harder for the central government to extract revenue from them, and thus revenue is more likely to stay in the local areas. Therefore, ownership and control make the difference.

Econometric studies on the data from China's rural industry provides some evidence to support the above theoretical arguments. Using panel data from 28 provinces in China between 1986 and 1993, Jin and

Qian (1998) found that the share of TVEs relative to private enterprises in rural industry in a province is higher if the initial collective assets under the control of community government is larger, or if the local political strength to resist pressure from higher level government (appropriately measured) is higher. This evidence is consistent to the theory that local government ownership of firms is related to the institutional environment. They also examined the consequence of ownership of firms on the revenue distribution among the national government, community government, and households. They found that a one percent increase in the share of TVEs relative to private enterprises is associated with a 0.11 percent increase in the shares of revenue accrued to the national government and a 0.24 percent increase in the shares of revenue accrued to the township/village governments. These results confirm the fiscal incentives of the local governments in developing TVEs, and also show that government control of firms plays an important role of substituting for taxation institutions.

C. "Financial Dualism"

China has generally managed macroeconomic stability well except for the periods of 1988-89 and 1993-94. China, no less than Russia, experienced a sharp government tax revenue decline. Then, what are the microeconomic and institutional foundations for its financial stability? The third institutional pillar of reform is "financial dualism" (McKinnon, 1993; Bai et al., 1999).

There are two aspects of financial dualism. One aspect concerns government revenue: although tax revenue sharply declined, it was accompanied, and thus partially compensated, by an increase of "quasi-fiscal" revenue from impressive financial deepening. This provides a basis for China's macroeconomic stability and avoids a financial crisis like Russia's (McKinnon, 1993). In China, consolidated government budgetary revenue as a share of GDP declined from 31 percent in 1978 to 13 percent in 1993. Taking into account the extra-budgetary and off-budget revenues, total tax revenue also declined dramatically, from 40 percent of GDP in 1978 to about 19 percent in 1993 (Bai et al., 1999). On the other hand, cash in circulation as a percentage of GDP was less than 6 percent in 1978, and increased to 16 percent in 1993. Total household bank deposits were less than 6 percent of the GDP in 1978, and they increased to about 50 percent in 1993 and further to 62 percent in 1997. The M2 to GDP ratio continued to climb, from less than 50 percent before the reform to more

than 100 percent in the 1990s (*Almanac of China's Finance and Banking*, 1996). What seems to be surprising is that the financial buildup lasted much longer than most economists expected. The result has been that the government was able to benefit from this financial buildup. By one estimation, between 1986 and 1994, the government collected quasi-fiscal revenue from the banking sector, averaging about 9 percent of the GDP, or more than one half of the budgetary revenue (Bai et al., 1999).

Bai et al. (1999) go one step beyond the macroeconomic issue of government revenue and study more fundamental microeconomic implications of fiscal-decline-cum-financial-deepening. They highlight the coexistence of two institutional arrangements in China's financial system. The first is the well-known one of financial repression, that is, a combination of government control on international capital flows with restriction on domestic interest rates and private financial activities. The second is what they called "anonymous banking," which is a combination of the government's relaxed regulation on the use of cash for transactions and permission to use anonymous household savings deposits. They argue that anonymous banking together with financial repression implies some major advantages over direct taxation in the institutional environment of China.

The conventional wisdom holds that taxation is less distortionary than revenue extraction from financial repression. But this view ignores the government behavior on taxation. In China, as in many developing and transition economies, because there is a lack of rule of law, the government has difficulties committing itself to fixed tax rates, let alone to low tax rates. Such a commitment problem undermines private incentives and is often regarded as a major obstacle to economic development as well as reform (North, 1997; Williamson, 1994). Bai et al. (1999) argue that anonymous banking provides a simple and effective commitment device to limit the government's predatory behavior and create private incentives. When transactions are made through cash rather than bank transfers, it is difficult for the government to monitor business transactions and thus to tax away the generated revenue. When bank deposits are anonymous, the government does not know the identity of depositors and thus is unable to target a particular person and confiscate his financial wealth. Although the government can still "tax" financial savings through inflation or regulating the interest rate, this method of revenue extraction is indiscriminate. In their model, Bai et al. show

that revenue extraction from the financial system can be costly to the government and thus it imposes a limit. Therefore, through anonymous banking, the government is able to achieve a credible commitment for creating private incentives. Through financial repression, although the government can acquire some quasi-fiscal revenue, it is more limited than discretionary taxation.[5] They conclude that indirect revenue extraction through the banking system has not just prevented revenue collapses, but more importantly, it has bound the government's hands and limited its ability for revenue extraction and thus is conducive to private incentives.

The other aspect of financial dualism concerns the lending side of the financial system. There was an asymmetry: State enterprises received the most credit from the state banks and faced soft budget constraints, while nonstate enterprises received only limited credit and faced much harder budget constraints. For example, the total size of the SOE industrial output was about twice that of TVEs in the late 1980s and early 1990s. However, loans to rural enterprises (mainly TVEs) accounted for only about 8 percent of all non-agricultural loans, while loans to SOEs accounted for about 86 percent (*Almanac of China's Finance and Banking*, 1993). While credit discrimination against non-state firms was often complained, such a discrimination became a blessing because when the non-state sector was subject to a hard budget constraint, it was more disciplined and performed better.

An intriguing question is why the state sector is subject to soft budget constraints and the non-state sector is subject to hard budget constraints. One main reason concerns the political benefits of the government. Historically, the government has been committed to the welfare of workers in the state sector in exchange for their political support, but not to those in the non-state sector. Therefore, when state enterprises perform badly, because the government values workers' employment, it will bail out them. Another main reason concerns the government's financial objective. In Bai et al. (1999) the government requires state firms to conduct transactions through state banks so it can conveniently observe them and tax them accordingly. In comparison, non-state firms often use cash for transactions and the government finds it hard to monitor and tax them. Given

[5] As a result, financial repression in China was "mild" because the real interest rate was not too negative. Indeed, during the past two decades, inflation was generally below 10 percent. In two periods of 1988-89 and 1993-94 when inflation rose to more than 20 percent per year, the government quickly indexed time deposits (over a three year maturity) to ensure a non-negative real interest rate.

this difference, the government would prefer to provide credits to state firms rather than to private firms because of its own revenue concerns. The downside of providing credit to state firms is their productivity, which implies a lower potential tax revenue. In Che and Qian (1998a), the difference comes from the control structure. In the case of an SOE, the government controls both the enterprise and the state bank. It therefore receives all the benefits from refinancing a project after sunk investments. This is *ex post* efficient, but makes an *ex ante* commitment to no refinancing less credible. In the case of TVEs, the community government controls only the TVEs but not state banks. This separation of control over firms and funds induces information asymmetry between the creditor (the state bank) and borrower (the community government on behalf of TVEs). Following the logic of Dewatripont and Maskin (1995), this information asymmetry reduces the benefits the state bank receives from refinancing a project after sunk investment. This in turn increases the *ex ante* credibility of no refinancing. Therefore, limited authority of a community government becomes a good thing and it serves as a commitment device to harden budget constraints.

D. Market Liberalization through the Dual-Track Approach

By the mid-1990s, prices of most products in China were completely liberalized. But the way the Chinese achieved this result is quite different from the way it was done in Eastern Europe. In Hungary, for example, after the 1968 reform, although all mandatory planning was abolished, prices were still determined administratively by bureaucrats subject to political bargaining. There was no real market, only a simulated market (Kornai, 1986). After 1990, on the other hand, prices were swiftly liberalized in one stroke. China took a "dual-track" approach to price liberalization under which the market was first liberalized at the margin while (inframarginal) planned prices and quotas were maintained and then phased out later. Under the plan track, economic agents were assigned rights to and obligations for fixed quantities of goods at fixed plan prices as specified in the pre-existing plan. In addition, a market track was introduced under which economic agents participated in the market at free market prices, provided that they fulfilled their obligations under the pre-existing plan. With this approach, real market prices and markets as a resource allocation institution were created in China in the very early stages of reform, which clearly differed from the Eastern European

experience prior to 1990.

Again the dual-track approach was often criticized by the economists who view it as a partial reform lacking the completeness of liberalization. But Lau, Qian, and Roland (1997, 1999) argue that such a perception is not correct, and the dual-track approach to market liberalization in fact has two advantages: it can liberalize markets without creating losers and thus is politically appealing, and it can also achieve efficiency under certain conditions. They show, in both partial and general equilibrium models, that independent of the initial conditions concerning supply and demand (such as whether planned prices or quantities are above or below the market equilibrium), as long as the pre-existing feasible plan continues to be enforced appropriately, the dual-track approach to market liberalization is always Pareto-improving. In addition, it also achieves efficiency under usual conditions such as profit maximization and perfect competition, provided market resales and market purchases for redelivery are all allowed.

Efficiency-enhancing economic reform should potentially allow winners to compensate losers, thereby making the reform Pareto-improving. However, in practice, it seems very difficult to find mechanisms that make economic reform Pareto-improving, and even more difficult for reform to be simultaneously Pareto-improving and efficient, because of the distortionary costs of compensation or a lack of credibility in its implementation. The dual-track approach provides one mechanism for the implementation of efficient Pareto-improving reform. The introduction of the market track provides the opportunity for economic agents who participate in it to be better off, whereas the maintenance of the plan track provides implicit transfers to compensate potential losers from market liberalization by protecting the status quo rents under the pre-existing plan. Thus, the dual-track approach is, by design, Pareto-improving. Moreover, as the compensatory transfers are inframarginal and thus lump sum in nature, the dual-track approach can be efficient too. While single-track (or "big-bang") market liberalization will lead to efficiency under the usual conditions (such as profit maximization and perfect competition) Pareto-improvement cannot be assured. Furthermore, with the presence of some market imperfection (such as search frictions or imperfect competition), single-track liberalization may cause a decline in aggregate output, as shown in the models of Blanchard and Kremer (1997), Roland and Verdier (1999), and Li (1999), but the dual-track approach can avoid this.

It is clear that enforcement of the plan track is crucial for preserving the pre-existing rents. However, sufficient state enforcement power is needed not to implement an unpopular reform, but to carry out one that creates no losers, only winners. One desirable feature of the dual-track approach is its minimal additional informational and institutional requirements: It utilizes the existing information contained in the original plan and enforces the plan through existing planning institutions. No new information and no new institutions are necessary.

Agricultural market liberalization illustrates that the dual-track approach can be both Pareto-improving and efficient. The commune (and later the households) was assigned the obligation to sell a fixed quantity of output to the state procurement agency as previously mandated under the plan at predetermined plan prices and to pay a fixed tax to the government. It also had the right to receive a fixed quantity of inputs, principally chemical fertilizers, from state-owned suppliers at predetermined plan prices. Subject to fulfilling these conditions, the commune was free to produce and sell whatever it considered profitable, and retained any profit. Moreover, the commune and households could purchase grain (or other) outputs from the market for resale to the state to fulfill its responsibility. Under the dual-track, the state procurement of domestically produced grains between 1978 and 1988 remained essentially fixed, while there was almost a one-third increase in grain output.

Industrial liberalization also shows how markets could grow out of plans (Byrd, 1991; Naughton, 1995). For coal, China's principal energy source, the planned delivery was increased somewhat from 329 million tons in 1981 to 427 million tons in 1989 (mainly because new state coal mines were opened), but the market track increased dramatically from 293 million tons to 628 million tons in the same period. The increments came mainly from small rural coal mines run by individuals and TVEs. For steel, another China's major industrial material, the plan track in absolute terms was quite stable, but the share of plan allocation fell from 52 percent in 1981 to 30 percent in 1990. Unlike coal, the supply response in steel came mainly from large SOEs rather than small non-state firms. In the cases of both coal and steel, because the plan track was basically "frozen," the economy was able to grow out of the plan on the basis of the market track expansion by state or non-state firms.

E. An Assessment

China's first fifteen years of reform was a remarkable success, judging by the results of fast GDP growth, elimination of shortages, and dramatic improvement in the living standards of ordinary people. By the end of 1993, reform was supported by people in all walks of life simply because everyone 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.

Central planning has long been criticized as an inefficient resource allocation mechanism compared with the market, but its failure has deeper institutional problems than simply planning mistakes or rushed development strategies. Fundamentally, the system is unable, in a credible way, to provide positive incentives to economic agents and to impose financial discipline upon them, and it also fails to create genuine competition. This had remained the case in Eastern Europe even during the economic reform in the 1970s and 1980s (Kornai, 1986).

China was able to avoid the fate of Eastern European reform prior to 1990 because of its deeper institutional changes. Each of the four pillars of institutional change analyzed above contributed to China's reform success since they changed the functioning of the government, firms, the financial system, and markets to unleash the forces of positive incentives, hard budget constraints, and competition, but in novel ways. For example, positive incentives were provided through a variety of means, such as fiscal contracting under regional decentralization, local government ownership, and information decentralization through the relaxation of the regulation on cash and permission of anonymous bank accounts. Harder budget constraints were imposed in circumstances when there are constraints imposed on the government, for example through control rights and information structures. Finally, competition was created not only among firms (both state and non-state) but also among local governments at provincial, city, county, township, and village levels. The Chinese experience has demonstrated that reforming the government and providing it with incentives is as crucial as reforming the economy; non-private and non-state ownership can be an engine of growth; financial stability can be obtained for an extended period through quasi-fiscal revenues from the banking system; and dual track liberalization provides one mechanism to minimize the number of losers of reform. Interestingly, none of these

methods were recommended by economists; to the contrary, all of them were criticized.

Despite these impressive achievements, there were many serious problems during this stage of reform. First, some mistakes were made. For example, decentralization of government went too far in the areas of monetary policy: local governments gained substantial control over the credit supply, and at one point, the bonuses of the central bank's local branches were even linked to the amount of credit they extended. This was a source of soft budget constraints of local governments and SOEs and of inflation as well (Qian and Roland, 1998).

Second, many difficult reforms were delayed. For example, no single state enterprise was privatized and almost none went bankrupt. This is in turn because of the delay of establishing a social safety net. There was also no effort made in establishing property rights protected by the rule of law and contract enforcement mechanisms. Although establishing a rule-based tax system was attempted, it failed and then delayed as well (Shirk, 1993).

Third, and most important, the achievements up to 1993 were made basically through institutional innovations which were either ad hoc responses to particular constraints in the planning system or took advantages of the loopholes in it. The varieties of contracting practices between different levels of government and between government and enterprises are good examples. Although they were effective in breaking the central command, they were ad hoc and subject to frequent renegotiation and change. In their empirical investigation, Jin, Qian, and Weingast (1999) found evidence of the "ratchet effect" over time under the fiscal contracting system: during 1982 and 1992 and on average, a 1 yuan increase of revenue collection this year leads to a 0.24 yuan increase of revenue remittance (or decrease of subsidies) in the next year. They also found that a majority of provinces received extra, though limited, subsidies beyond contractual stipulation, an indication of some soft budget constraints. While the adverse incentive effect of these problems in the case of inter-governmental relationships might be modest, it could be much more serious in the case of the managerial contract responsibility schemes in the SOE reform (Wu, 1995; Qian, 1996).

3. Replacing the System: Since 1994

Since 1994, China's transition has moved into the second stage which aimed to replace the planned system with a market system. I will address three issues in this section. First, I will show that China set a goal, becoming clearer over time, to establish a rule-based market economy incorporating international best practice institutions as we know them. In fact, China has become the first and the only country in which the ruling Communist Party voluntarily shifted its official ideology to embrace a market system and private ownership. Because many people outside China are still unaware of it, I will provide some detailed evidence to show that this is indeed the case. Second, I will examine advancement in several major areas toward this goal in the first five years of the second stage (between 1994 and 1998). The evidence shows that significant progress has been made, which should clarify many doubts over whether China's reform is continuing. Finally, I will provide an analysis of the political economy of reform and the dynamics of transition, focusing on how the early reforms created constituencies and momentum for further reform without generating obstacles to block it.

A. The Strategic Move: Setting the Goal for a Market System

At the outset of reform, China desired reform in order to increase productivity and improve living standards, but at no time did the leadership think that it was to go for a full market system (Perkins, 1994). This started to change in the early 1990s. However, establishing that goal in China was an evolutionary process, and in that aspect, China is unlike some Eastern European countries whose goal was very specific at the beginning of transition, that is, to build a market economy like their neighbors and join the European Union. I will highlight four consecutive milestone events in September 1992, November 1993, September 1997, and March 1999, respectively, to show how this strategic move has evolved progressively over time.

The Fourteenth Party Congress of September 1992. During much of the first stage of reform, the official ideology was the one of "combining plan and market together." A more conservative version of it was "planning supplemented by market" and a more liberal version was "planned commodity economy." Clearly, the goal of reform was not a market system. 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 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, market is a simulated one to serve the purpose of socialism based on public ownership (Kornai, 1992). In contrast, in a socialist market economy, "market economy" is the goal and the word "socialist" in an adjective. Therefore, a socialist market economy differs from a market socialism in a fundamental way while it is closer to the "social market economy" of Germany.

The Decision of November 1993. The contents of transition to "socialist market economy" only 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.[6] With the objective of a market system in mind, this landmark document made four major advances in the areas of reform strategy, a rule-based system, building market-supporting institutions, and property rights and ownership respectively. It was the turning point on China's road to markets.

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

Second, in the first stage of reform, particularistic contracting played a dominant role, such as fiscal contracting, managerial contracting, and household contracting. For the first time, the "Decision" called for a rule-based market system to create a level playing field. This included the decision to unify the foreign exchange rate and tax rates among all enterprises regardless of ownership. Shortly before the "Decision," China already had adopted Western accounting rules in its enterprises.

[6] For the full text of the "Decision," see *China Daily, Supplement*, November 17, 1993.

Third, the "Decision" focused on the 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. Another example was centralization of the operation of the central bank to minimize the local government's influence on monetary policies.

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

The Fifteenth Party Congress of September 1997. In the "Decision" of November 1993, state ownership was still regarded as a "principal component of the economy" while private ownership was a "supplementary component of the economy." The Fifteenth Party Congress held in September 1997 made a major breakthrough on ownership issues: State ownership was downgraded to a "pillar of the economy" and private ownership was elevated to an "important component of the economy." In Chinese politics, these subtle changes of rhetoric mean a big change in ideology. 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 many owners. At this time, the official ideology toward private ownership finally became "friendly."

The second major breakthrough of the Fifteenth Party Congress was its emphasis on the rule of law. 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. China seemed to decide to give priority to the rule of law rather than democracy in its sequencing of political reforms and to consider the rule of law crucial for a modern market economy to work well.[7] As always in China, the content of the rule of law will evolve over time.

The Constitutional amendments of March 1999. Private ownership and the rule of law were incorporated into the Chinese Constitution in March 1999.[8] An amendment of Article 11 of the Constitution places private businesses on an equal footing with the public sector by changing the original clause "the private economy is a supplement to public ownership" to "the non-public sector, including individual and private businesses, is an important component of the socialist market economy" (*China Daily*, March 16, 1999). Immediately after the amendment, local governments started to relax local restrictions on private enterprises. For instance, the Jiangsu provincial government adopted a new policy to give private enterprises equal treatment as state-owned and collective enterprises in the areas of granting business scopes and credit access (*People's Daily*, April 9, 1999). Furthermore, Article 5 of the Constitution was amended to include the principle of "governing the country according to law" (*China Daily*, March 16, 1999). These Constitutional amendments have demonstrated China's commitment to a full market system based on the rule of law.

The significance of the strategic move. The failure of Eastern European reform prior to 1990 has made persuasive arguments for the necessity of having democratic reform precede economic transition (Kornai, 1992). The Communist Parties there were unwilling to change their ideology. The collapse of the Communist Parties in Eastern Europe was the logical consequence. China provided a case that proved impossible in Eastern Europe and elsewhere: the Communist Party of China itself made the strategic shift voluntarily. It appears that China is the first and only country under the Communist Party to embrace private ownership and

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[7] Kornai (1998) has emphasized that democracy is not a necessary basis of a market system but a political power that is friendly to private property and the market is.

[8] "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).

the rule of law in its Constitution.

It is quite remarkable for China to have overcome ideological and political opposition to embrace the market system and private ownership without a political revolution. There were both internal and external reasons. The internal reason was that by 1993 reform in China had benefitted almost everybody, who envisioned bigger benefits from further reform. Solid political support for further reform came from both the top leaders and the ordinary people, which provided a political basis for ideological change (more on this in subsection C below). The external reason was that the outside pressure from East Asian countries was enormous; their extra-ordinary performance pressed China to move forward. At the same time, competitive pressure from the Eastern European transition to markets was also significant. The Chinese government feared that these transition economies would soon catch up with China, which might undermine its legitimacy that was built entirely upon the economic performance of the country.

The popular sentiment in China for a transition to a conventional market economy can be sensed from the two phrases which have been popular in the 1990s: *yu guoji jiegui*, which means connect to (or join) the international track (or practice, or standard); and *guifan hua*, which means standardization. In November 1998, major newspapers in China published Joseph Stiglitz's (1998) article "Second-Generation Strategies for Reform for China," which contains policy recommendations for China for deeper institutional restructuring to complete its transition. This can be interpreted as a strong determination from the top leadership to complete China's move to markets.

B. Major Accomplishments in the First Five Years (1994-98)

Following the "Decision" of November 1993, a series of radical reforms were launched starting in January 1994. In building market institutions, China started a little bit late compared to Eastern Europe or even Russia. Today, it still lags behind the star countries in Eastern Europe such as Poland, Hungary, and the Baltic countries. But this group of countries may be exceptional because of their aspirations to join the European Union. So far, China's progress has been steady, and it has been able to avoid bad mistakes made by some other transition economies.

In building a market system, China continued its previous practices that were useful, such as government decentralization, financial stability, and compensation for losers of the reform. It began to address the three problems left from the first stage. First, it corrected some early mistakes, such as monetary decentralization and soft budget constraints on local governments and SOEs. Second, it began delayed reforms, such as privatization of state enterprises and commercialization of state banks. Third, and most important, China started to incorporate international best practice market institutions based on uniform rules, but while doing so, it first created new institutions before destroying the old ones. Below, I examine some major accomplishments in the first five years. Many of the reforms will continue into the next decade, but the evidence so far shows that China is moving in the right direction and proceeding at a steady pace.

Unification of foreign exchange rates and convertibility of the current account. 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 to announce current account convertibility of its currency. However, it did not move to capital account convertibility and yet still maintained capital control. This is one important reason that China weathered the Asian financial crisis rather well.

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

The overhaul of the tax and fiscal systems. Before 1994, the fiscal contracting system had played a positive role of providing badly needed incentives for local governments. But the fiscal contracting was ad hoc

and was not rule-based. Also, China did not have a national tax bureau, and all taxes were collected by local governments, which often reduced or exempted 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 reduce 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, but the central government could have deficit financing in its capital account although it had to finance the deficit with government bonds. It also imposed more stringent restrictions on local governments: Local governments at all levels were required to have their budgets balanced (as before), and furthermore, the law strictly controlled their bond issuance and restricted their borrowing in the financial market (a change from the past). To ensure enforcement of the "Budget Law," an independent auditing system was also introduced. 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.

Monetary centralization and financial reform. One of the mistakes in the first stage of reform was monetary decentralization, which was responsible for the inflationary pressure and soft budget constraints of local governments (Qian and Roland, 1998). Before 1994, 70 percent of the central bank's loans to state banks were made by the central bank's local branches, which were heavily influenced by the local governments. In 1993, the central bank centralized its operation after Vice Premier Zhu Rongji became its governor. Since then, its local branches have been supervised only by the headquarters of the central bank, not as before also by the local government of the region in which they reside. In 1995 China passed the "Central Bank Law" to give the

central bank the mandate for monetary policy independent of the local government. These reforms substantially reduced the local government's influence on monetary policy and credit allocation decisions (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, in fiscal channels because of the tax reform and in financial channels because of the monetary reform. In 1998, the central bank further replaced its 30 provincial branches with 9 cross-province regional branches as in the U.S. Federal Reserve system.[9] This reform further minimized the local governments' influence on monetary policies.

Since 1994 some progress has been made to commercialize four major state banks. 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. Starting in 1998, the central bank abandoned the credit allocation ceilings imposed on these banks, replacing them with standard reserve requirements, assets-liability management, and interest rate regulations. At the same time, foreign banks were allowed to open branches in China, initially restricted to special economic zones but later extended to all major cities.

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

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[9] The nine regional branches are located in Shenyang, Tianjin, Jinan, Nanjing, Shanghai, Guangzhou, Wuhan, Chengdu, and Xi'an.

Downsizing of the government bureaucracy. Lessons from transition economies have told us that reforming the government is a critical part of institutional reforms and perhaps more fundamental than economic liberalization (Shleifer, 1997). Despite many early reforms, the basic government bureaucratic structure in China was still kept intact from the planning era, for instance, many industrial ministries remained for supervising SOEs. In early 1998 a major reform for streamlining the government bureaucracy took place. Most industrial ministries, such as the textile and machinery industries, were abolished and replaced by much smaller corresponding bureaus, which were then absorbed into the State Economic and Trade Commission. Some new ministries were created, such as the Ministry of Social Security. The number of ministries in the central government was trimmed from 45 to 29 (a similar action will be taken at the local level in 1999), and the number of civil servants was cut by half, from 8 million to 4 million. To compensate for the losses, displaced civil servants were sold apartments at discount prices according to their seniority and were given an option to study for undergraduate and graduate degrees with tuition and stipends paid by the government for three years.

Chinese enterprises have had close ties with the government. Sometimes such a tie is an advantage, as in the case of TVEs, but in some other cases, the disadvantage clearly outweighs the benefits. This is particularly true with business enterprises owned and managed by the military, police, and judiciary branches of the government. In the second half of 1998, the government severed all the ties between these government agencies and their business enterprises. The military, police, and judiciary branches of the government now solely rely on tax revenues to maintain their operations, not on business incomes. The earlier reforms of downsizing the government bureaucracy set good precedents for severing the ties of the military with business enterprises. In the meantime, a major campaign of anti-corruption and anti-smuggling was undertaken, and the reform of the judiciary system also began. For instance, the first live TV coverage of a civil trial took place in the summer of 1998. These reforms of the military, police, and judiciary systems represent a crucial initial step toward the rule of law.

Privatization of state-owned enterprises and layoffs of state workers. China delayed privatization

of SOEs, and in fact, did not privatize any state-owned enterprises or lay off any state workers prior to 1992.[10] While delays sometimes can be justified on the grounds of a lack of appropriate social security institutions supporting the unemployed, there are high costs associated with delays. Privatization of SOEs and layoffs of state workers began to emerge on a large scale in 1995 (Cao, Qian, and Weingast, 1999). This reform has made significant progress in two areas: privatization of small SOEs at the county level and mass layoffs of SOE workers at the city level. In these two areas of reform, local governments have been the driving force.

Privatization of SOEs started initially by local governments as experiments in a few provinces, such as Shandong, Guangdong, and Sichuan. Later, the central government promoted it with the slogan of "grasping the large and letting go the small" (*zhuada fangxiao*)." One interpretation of "grasping the large" is to keep about 1,000 large enterprises as state owned. Privatization of small SOEs was very significant for China, because, in contrast to Eastern Europe and the Soviet Union, China's industrial SOEs were dominated by small- and medium-size enterprises. In 1993, they accounted for 95 percent in number, 57 percent in employment, and 43 percent in output of the state industrial sector. Most of these enterprises were under the supervision of county and city governments. By the end of 1996, up to 70 percent of small SOEs had been privatized in pioneering provinces and about half were privatized in many other provinces. Although in 1998, the process slowed down somewhat because of the Asian economic crisis, the trend already became irreversible.

There are many SOEs which are either not viable or are overwhelmed with excess employment. For these firms, reallocation of labor is the main concern. About ten million workers from SOEs and urban collectives were laid off by the end of 1996, and an additional 11.5 million workers were laid off in 1997. This layoff itself was a big achievement for reform: never before were state employees laid off and state enterprises closed down. Two institutions accompanied the mass layoff: *xiagang*, or "stepping down from one's post" and *zaijiuye*, or "reemployment program." Cao, Qian, and Weingast (1999) argue that these two institutions have important mechanisms for providing credible means to compensate laid off workers in the absence of a social safety net and to help them find new jobs. When the government uses *xiagang* to lay off workers, they continue

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

to receive some payment from the enterprises, which reduces their resistance to reform *ex ante*. With *zaijiuye*, the government also creates an *ex post* environment in which workers, having new jobs, are less likely to demand more subsidies. Together, they not only buy the cooperation of SOE workers, but buy them out.

C. The Political Economy of Reform and the Dynamics of Transition

The political economy of reform concerns how reform can be initiated and pushed forward when it results in losers and winners. In analyzing the political economy of reform in China, one needs to answer two questions. First, how was the opposition to reform by the old vested interests overcome in order to initiate a reform? And second, how was the possible opposition to reform by new vested interests (who were the interim winners) overcome in order to move reform forward?

The initialization of reform in China needed to overcome political opposition from the existing vested interests under central planning. Motivated by the Chinese reform experience, Dewatripont and Roland (1992) and Wei (1997) have shown that in the circumstance in which a comprehensive reform package is unable to win majority support, a sequence of partial reforms may be able to win majority support each time. This is known as the "divide-and-rule" strategy. Indeed, the initialization of some of China's early reforms can be analyzed from this perspective. For example, special economic zones and regional experimentation can be viewed as ways to overcome ideological and political constraints. The preferences of particularistic contracting over universal rules can also be viewed as compromises for the same reason (Shirk, 1993). Therefore, some observed patterns of incremental and partial reform in China can be attributed to this divide-and-rule strategy. On the other hand, precisely because of these wise political compromises, China (prior to 1994) could undertake much more radical reforms compared to the reforming countries in Eastern Europe (prior to 1990).

By the end of 1993, China's economic system as a whole was halfway between a planned and a market economy. Would the incremental reform continue or would partial reform block further reform? There are theoretically two opposite effects of partial reform. In the models of Dewatripont and Roland (1992) and Wei (1997), a sequential reform strategy has an important advantage of building constituencies at the interim stage of reform. In addition, Dewatripont and Roland's model (1995) incorporates aggregate uncertainty and has

the feature that a sequential reform strategy can build momentum as well as constituencies for further reform. This is because when beginning with reforms that give a higher likelihood of a good outcome for a majority, the majority will obtain interim stakes and then may want to continue reforms when they are complementary to the previous ones.

In China, the early agricultural reform created constituencies who were, with their increased wealth, interested in developing rural industrial firms and liberalizing markets. In 1994 because of the earlier massive entry of non-state enterprises, in the industrial sector, the state's share of output accounted for only 40 percent of the national total, which clearly made privatization of SOEs much easier politically. Similar actions in 1978 would be very different political consequences when the state's share was about 80 percent. Also, as discussed in subsection A above, the support generated by the momentum of earlier reform success in the 1980s provided a political basis for the ideological change in the 1990s.

On the other hand, there are also difficulties for pushing reform forward because the early partial reforms may have also created new vested interests which might be against further reform. Hellman (1998) emphasized this possibility based on the Eastern European transition experience and provided some evidence showing that it was the interim winners, not the losers, of partial reform who blocked further reform in some countries of Eastern Europe. He considered this situation one of "winners taking all," which presents a serious political problem resulting from the incremental reform strategy. But the evidence provided in subsection B above shows that both the old and new vested interests have not blocked China's further reforms in the past five years. Thus, China provides a case in which the winners of early reforms were not necessarily the eventual losers nor did these winners manage to "take all."

Why hasn't the "partial reform trap" occurred in China as in some other transition countries? Three reasons seem relevant. The first reason is the nature of the early reforms. In some sense, all reforms are partial, but not all partial reforms are equal. Some partial reforms create huge rents for the concentrated winners but others do not. Many of China's early reforms seem to belong to the latter category. First, the agricultural reform in China can be viewed as a partial reform because it was almost the only sector that significant reform was undertaken in the late 1970s, but liberalization in agriculture was quite thorough and

did not create many rents. Second, regional decentralization diversified rent distribution away from the central government, and inter-regional competition among local governments, however imperfect, also limited the amount of rent accrued to local governments. Third, fast entry and expansion of non-state firms, many of them local government firms at the township and village levels, created a competitive environment which eliminated many of the rent. Fourth, capital control was responsible for limiting the amount of rents to be capitalized and invested abroad. Fifth, the enforcement of the plan track under the dual-track liberalization not only preserved old rents, but also limited new rents because a firm that received subsidized inputs was obligated to deliver a quota output at a low price as well. Finally, a lack of natural resources and the omission of a mass privatization program also helped reduce rent. As a result, during China's first stage of reform, the benefits were relatively evenly distributed, there were not many losers, nor were there concentrated winners with huge gains. Thus, equity played an important political role in reform by avoiding many losers who could reverse it and huge winners who could block further reform.

The second reason is the potential future gain from the increased market size and the efficiency resulting from further reform. The bigger these gains, the less important the loss of the current rent. This seems to be the case for the reform of the tax and fiscal systems in 1994. Although some local governments (such as Guangdong) benefitted tremendously from the earlier fiscal contracting system, they also rightly recognized that the ad hoc nature of the contracting system created many uncertainties and that the political pressures from other provinces had also increased. Therefore, it was in their long-term interest to move to a rule-based tax system rather than insist on the ad hoc contracting system.

The third reason is that both the old and new vested interests were "bribed" when further reforms were introduced. Of course, this was feasible only when the rents were not too large. For example, among the above mentioned reforms after 1994, such as unification of the foreign exchange rate, tax reform, downsizing the government bureaucracy, and layoffs of state workers, potential losers were all compensated to different extents. Compensation for the interim winners was politically important for pushing reform forward, rather than leaving it in a "partial reform trap."

Incremental reforms can both build up momentum and constituencies for further reform and create

obstacles to block it. Therefore, one needs to closely examine how partial reforms are structured and how rents are distributed. China's twenty years of reform experience have demonstrated that incremental reform does not necessarily lead to a partial reform trap. Still, one cannot reach a more definite conclusion at the present time because China has not yet completed its transition to markets. Indeed, China still faces some major challenges, the topic I turn to in the next section.

4. Completing China's Transition: Challenges Ahead and Priority Research Agenda

By the end of 1998, much had been accomplished but there was still more to be done before China became a market economy and realized its full potential. In this section, I will highlight three major areas which may pose the most serious challenges for China: the financial system, state-owned enterprises and corporate governance, and the rule of law. In each area, I will examine the major difficulties involved in further reform, outline the required deeper institutional changes, suggest some ways to achieve them, and propose future research topics. The reforms in these three areas will be difficult but also crucial for China to complete its transition to markets, and therefore, their study should be a research priority.

A. The Financial System

As discussed in section 2, China's financial system served well, for an extended period of time, in mobilizing financial savings and providing the government with quasi-fiscal revenue. At the present time, the previous fears of inflation and macroeconomic instability are largely gone, and in fact, deflation becomes a major worry. However, the institutions underlying China's financial system remain primitive and weak, and moreover, the banking system has become more and more fragile because of the increasing amount of accumulated non-performing loans in the state banks. Total non-performing loans were estimated in the range of 17-25 percent of GDP by 1993 (Lau and Qian, 1994), increasing to the range of 25-35 percent by 1997 (Lardy, 1998). These numbers are high by any standards. China's current financial system is not sustainable in the long run.

China has recognized its risks of a financial crisis and put financial stability as a top reform objective

amid the Asian, Russian, and Brazilian financial crises and the Japanese financial troubles. The main reason that China weathered the financial crisis better than most of its Asian neighbors was its defensive and cautions approach to financial liberalization: China maintained capital control and restricted the entry of nonstate banks and regulated interest rates. A financial crisis might occur in the future in several circumstances. First, if the non-performing loans keep rising to dry out government budget for servicing its debt and to increase inflationary pressure. Second, if some severe shocks occur when reforms deepen in areas such as liberalizing the banking sector and loosening capital control. Third, if the depositors lose confidence in the state banks, which can be triggered by exchange rate or political instability.

Some economists have expressed a pessimistic view of a coming financial collapse in China similar to, or even worse than, those experienced in Asia and Russia. However, they have ignored some basic differences between China and those economies. These differences have reduced the likelihood of an occurrence of the three circumstances described above, and thus, at the present time, a financial crisis in China is not inevitable and the Chinese government still has some time to fix its financial system before it becomes really late.

First, the banks in China are state-owned and thus their bad debts are simply government, not private, debts. By the end of 1998, explicit government debts were about 10 percent of GDP. Assuming that one half of the non-performing loans are not recoverable, then total government debts, including the bad debts in state commercial banks, would still be less than 30 percent of GDP. This level of government debt compares favorably with the 70 percent in the U.S. and over 100 percent in Japan currently, or the 60 percent maximum required to join the European Monetary Union. Considering the fact that the taxation ability of the Chinese government is about one-half of that in the developed countries, the burden of servicing the government debts as a share of the government budgetary expenditure is still comparable to other countries and thus manageable.

Second, these bad debts are domestic, not foreign, debts. As long as the state continues to control the international capital flow and make restrictions on domestic interest rates and the entry of domestic and foreign banks, the government still has the instruments of financial repression at its disposal. This will help reduce the government's costs of financing its domestic debt.

Third, exchange rate or political instability seems not to be an immediate concern for China now.

Although a financial crisis in China is not imminent, a drastic financial reform is needed, the sooner the better. Two problems need to be distinguished, one concerning the "stock" problem and another the "flow" problem. Lau and Qian (1994) argue that, although the two issues are related, the more important one is the latter, that is, to stop new bad loans from appearing now and in the future, rather than the former, that is, to clean up the balance sheet. The stock problem is largely a problem of the past. The money has already been lost, and it is an accounting exercise to determine where and how the losses should be recognized, which is mainly a problem of rents redistribution. Solving the flow problem is more important because it affects future expectations and behavior.

Solving the flow problem requires a banking reform (but ultimately, an SOE reform, to be discussed in subsection B below). Since 1998, the Chinese state banks have been given the capacity to run on a commercial basis rather than on instructions from the government as in the past. There are signs that state banks reduced lending to large loss-making state enterprises and shifted their lending priorities to small and medium-sized non-state enterprises. Competition from foreign banks also emerged. These are encouraging signs.

To solve the stock problem of cleaning up the banks' balance sheets, Lau and Qian (1994) proposed establishing a trust fund organization (called "Enterprise and Bank Reconstruction Fund"). This trust fund serves as an intermediary to issue bonds to the state banks, which would partially offset their losses created by the non-performing loans. They also proposed recapitalizing the state banks through possibly issuing preferred stock (with no voting rights) to the public. The non-performing loans would then be written down to zero on the banks' balance sheets but a 50 percent across-the-board interest in these loans would be transferred to the trust fund so that it would benefit if a portion of them were recovered. The role of this trust fund is similar to that of the Resolution Trust Corporation (RTC) of the U.S. used in cleaning up the mess resulting from the Savings and Loans crisis in the 1980s. Along this line, the Construction Bank of China, one of its four major state commercial banks, was recently selected by the central bank to experiment with ways of cleaning up its bad debts through a newly established "financial assets management company" (*Singtao*

Daily, March 6, 1999).

The financial reform requires careful research on both the flow and stock problems. To address the flow problem in a fundamental way, China needs to introduce a bankruptcy procedure which clearly specifies the rights and obligations of creditors (at present time mainly state banks) in the event of bankruptcy of both liquidation and reorganization types. In particular, banks, as major creditors, should have the rights of receivership and the responsibility for reorganization of the bankrupt firms. Because the current Chinese law does not allow banks to hold any equity of firms, research is needed to introduce new regulations which permit banks to temporarily hold equity during the reorganization period. On the issue of cleaning up the bad debts of state banks, one needs to find a way to ensure that such a clean up will not result in a moral hazard problem from the state banks. To that end, the government must make a credible commitment to no more bailouts in the future. Research is also needed to identify methods to achieve this goal.

Another research topic concerns appropriate sequencing of financial liberalization. In the case of Japan, Hoshi and Kashyap (1999) argue that it is not the Japanese main bank system per se but the problematic sequencing of financial deregulation that explains its banking crisis. Deregulation allowed large corporations to quickly switch to the capital market for direct financing, but at the same time, the banks' new lending primarily flowed to high risk small businesses and became tied more strongly to the bubble economy. As the bubble burst, a banking crisis emerged. China may face similar problems when its state banks become more independent from the government and shift their lending portfolios to smaller firms. To reduce financial risks at the time of financial liberalization, China needs to learn lessons from the recent Asian experiences.

B. State-Owned Enterprises and Corporate Governance

Reforms of state-owned enterprises have been disappointing. The managerial contract responsibility system promoted in the 1980s had only limited success and SOE performance in the 1990s continued to decline (Wu, 1995). For instance, there were more one-third of SOEs making losses, and on average, profits and taxes per unit of net capital stock and working capital in state industrial enterprises fell from 24.2 percent in 1978 to 12.4 percent in 1990 and further down to 6.5 percent in 1996 (*China Statistical Yearbook*, 1997). Even

though new private firms are developing and small SOEs are being privatized, this is not a substitute for transforming large SOEs, since they still constitute the backbone of the economy, are the main revenue source and financial burden for the government, and are ultimately responsible for the financial sector problem.

Although the excessive "social burdens" of SOEs (i.e., workers welfare obligations) are often blamed for their poor performance, the main problems are institutional, concerning finance (the soft budget constraint problem) and personnel appointments (the Party control problem). The soft budget constraint problem has been discussed in sections 2 and 3, and in recent years the budget constraints of SOEs have been hardening. But Party control over personnel has remained basically unchanged for the past 20 years. The Party has exercised control over the selection and dismissal of SOE managers through its Organization Departments at different levels. For example, the Central Party Organization Department has the authority over appointments of the top managers of very large SOEs (minister or deputy minister level), as does the Provincial (or Municipality) Party Organization Department for most large and medium-sized SOEs (bureau level). This authority applies to joint-stock companies as long as the state has the majority share, even if they are listed on the stock market or are located in the special economic zones. The appointment and dismissal process represents the most important channel of political influence over enterprises by the Party apparatus.

Under the Party control personnel system, SOE managers, like mayors, ministers, and Politburo members, are political appointees of the Party. This political process of managerial appointments has several serious problems. First, the appointment process is politicized, secretive, and complicated. When the Party selects both managers and politicians at the same time, it may not choose the right people as managers. Second, the selection and evaluation methods are based on information through bureaucratic rather than market channels (the latter includes the stock market, rating companies, and investment banks). Third, the Party bureaucrats have neither the ability nor the incentives to make the right decisions on managerial selection according to business criteria because they are mainly politically motivated.[11]

Through "expanding enterprise autonomy" and "increasing enterprise retained profits" (*fangquan*

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[11] It is interesting to compare SOEs with TVEs in this regard. Although TVE managers are appointed by township or village governments, they do not go through the higher level Party apparatus and thus they are not subject to the same political process as SOE managers. After all, most TVE managers are not "state cadres."

rangli), the past reforms improved managerial incentives somewhat but the effect was rather limited and short-lived. Why? The main difficulty of reforming SOEs without privatizing them is reflected in the following institutional dilemma (Qian, 1996): On the one hand, 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, resulting in high political costs. The SOE problem in China is the intertwining problem of both high agency costs and political costs.

Before being privatized, large SOEs (including state banks) should aim to reduce both agency and political costs, which can only be achieved by a combination of establishment of corporate governance and depoliticization (Qian, 1996). 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 (1) how control rights are allocated and exercised; (2) how boards of directors and top managers are selected and monitored; and (3) how incentives are designed and enforced. Corporatization, a process of establishing corporate governance, is a useful step in enterprise reform even without privatization, because it helps hold directors responsible for the assets of the company and prevent further asset theft; provide a mechanism for information exchange; set the stage for selling shares; and separate the state from enterprise. In Eastern Europe and in other developing countries, corporatization was carried out before privatization and improved enterprise performance.

In developed economies, major issues of corporate governance concern legal rules limiting the agency problems, protecting shareholders and creditors, and providing room for managerial initiatives. The same problems arise in China, but with a special concern about the role of the state as a large stakeholder. In addition to corporate governance, depoliticization is also necessary, which means that the Party's direct control over managers should be limited, if not eliminated. Unless the issue of the Party's role is addressed, the goal of "separation of government and enterprise" cannot be materialized, and 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 large firms.

Corporatization and depoliticization are difficult tasks for China because they necessitate some political reform. Future research needs to find a way to limit the Party's role in the appointment and dismissal process of SOE managers without eliminating its leadership role. There were suggestions about the creation of the State Assets Management Committee to oversee state assets in enterprises. In such a scheme, only the Committee representatives have authority, through the board of directors and depending on the number of shares held by the state, over the appointment and dismissal of top managers (World Bank, 1997). Many questions remain. For example, who will appoint the members of the State Assets Management Committee? The Party, a government agency, the People's Congress, or others? Will such a person or institution stop interfering the appointment and dismissal process of the board of directors? More research is needed to make the scheme politically acceptable and economically sensible.

C. The Rule of Law

The biggest challenge for China to complete its market transition is the establishment of the rule of law. The recent Constitutional amendment on the rule of law is a good start. The economic advantages of the rule of law over ad hoc arrangements are transparency, predictability, and uniformity, that reduce idiosyncratic risks, rent-seeking, and corruption, which in turn reduce transaction costs. But the rule of law is more than putting the government's words into public codes; it fundamentally concerns a relationship between the government and markets that is appropriate for making a credible commitment.

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 secure private property rights against government intrusion, and it reflects the crucial difference between the "rule of law" and the "rule by law."

One serious problem undermining private incentives in China has been insecure private property rights.

For example, private enterprises and farmers are frequently forced to pay variety of "unauthorized fees" to local governments, and their businesses are also harassed by local governments. Revenue hiding is a response to government predation, but is costly. Recently, private businessmen and farmers began to use legal means to protect themselves against government's intrusion. For example, *The Wall Street Journal* (March 25, 1999) reported a 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 now the case is before the Shaaxi Provincial Supreme Court. This is an unprecedented event in China.

The second economic role of the rule of law is that the government needs to protect private property rights and enforce contracts and to create a level field for market competition. This will help achieve credible commitment among economic agents. To achieve this goal, the government needs to become a neutral third party, a regulator rather than a manager. During the recent restructuring of the government bureaucracy, many government agencies were eliminated and the role of the newly established agencies has been reoriented from management to regulation. One example is the Ministry of Information Industry. It used to directly administer China Telecom, the telephone monopoly in China. Now, China Telecom is being broken up into three companies, while foreign competition is being introduced, and the Ministry becomes the regulatory agency for the entire telecommunications industry (*Singtao Daily*, March 6, 1999).

To preserve market competition, the national government needs to fight against regional protectionism. In the past, market competition in China was largely an accident of regional decentralization under Mao, combined with the more-or-less spontaneous emergence of small-scale industries throughout the country. From time to time, there have been many reports that local governments erected trade barriers to block goods and factor movement in order to protect local interests. China needs a "Commerce Clause" as in the U.S. Constitution and the central government should have the responsibility to police the common market against regional market protectionism.

Future research is needed to study specific ways of implementing the rule of law. For example, an important topic concerns how to create a substantially independent judiciary system, starting at the grassroots

level, and then gradually moving upward. The rule of law requires an independent and uncorrupted judiciary system to function. A completely independent judiciary system seems impossible under a one-Party system, but it may not be necessary for the time being because a substantially independent judiciary system can achieve quite a lot economically for the rule of law to work. The latter can be done because China is such a large country and most of the economic decisions are made at the local level. Building a judiciary system that is independent of the local government's influence is feasible at the present time, and the above example of 12,000 farmers in Peijiawan village suing the local government illustrates this possibility.

Two decades ago few economists predicted that China would go this far and accomplish so much. China has surprised the world. Although past performance is no guarantee of future results, there are good reasons for being optimistic. Today, the ideology against markets and private ownership has subsided, the goals of transition have been set, many market-supporting institutions are being built, and the Chinese people are more willing than ever to integrate China's economy with the global one. For China to successfully complete its transition to markets, priority on the research agenda should be given to the three areas outlined above.

5. Reflections on the Economics of Reform and Institutional Change: Lessons from China

Economists often offer advice to transition economies based on their knowledge about economics. But economics has as much to learn from the experiences of the transition economies as it has to teach them (Walder, 1995). This can be done in two ways: One is by using the data generated from the transition economies to test existing economic theories. Another is through inspiration from the experiences of the transition economies to extend the existing theories or even develop new ones. Studying China's reform is useful for both purposes. Much research has been done using data from China to test existing theories. But studying China's experience is even more useful for generating new theories, especially in the area of institutional changes. This is because China's transition path is so unusual that it casts doubt on much of the conventional thinking on fundamental issues concerning system changes and the process of reform (Chow,

1997).

A. Reflections on the Principles of System Change

China differs from Eastern Europe and Russia in many important ways including their initial conditions. China had a large agriculture sector which was the spring board for its reform; China's more decentralized planning system made it natural to pursue reform in a more decentralized way based on regional experiments; and the ten year turmoil of the Cultural Revolution discredited central planning and substantially weakened the government (including the Party) bureaucracy and its vested interests.[12] Hence, China is unlikely to provide a model for Eastern Europe or Russia to follow. However, because our previous thinking on reform and transition was almost exclusively based on the experiences of Eastern Europe, the conventional wisdom is biased. It is therefore useful to incorporate China -- the larger half of all transition economies -- into the analysis.

It is commonplace to compare the Chinese reform experience since 1978 (and often, up to 1994) with the transition experiences of Eastern Europe and Russia after 1990 and to contrast the difference between the two as "gradualism" vs. "big bang." This is an inappropriate comparison. In Eastern Europe, reforms started as early as 1968 in Hungary, 1980 in Poland, and 1985 in the Soviet Union. China, Hungary, Poland, and the Soviet Union all went through a two-stage process: first reforming the planned system and then building the market system. When comparing China with Eastern Europe at a comparable stage, I draw three conclusions.

The first conclusion, based on China's achievements during the first fifteen years of reform, is that reforming a planned economy, both as a single event and as a step along the longer path, can be successful. The reforms in Eastern Europe prior to 1990 were a failure. Kornai (1992) made a convincing analysis of them and reached the following conclusion: "In spite of generating a whole series of favorable changes, reform is doomed to fail: the socialist system is unable to renew itself internally so as to prove viable in the long run." In retrospect, the reforms undertaken in China between 1978 and 1993 were much more comprehensive and

[12] Due to space limitation, this paper will not discuss how initial conditions affect the transition path. See Qian and Xu (1993), and Sachs and Woo (1994) for discussions.

radical than those in Eastern European prior to 1990, the latter having no serious reform of the government, no dynamic development of non-state enterprises, no financial deepening, and no real markets. That is why China's early reform was more successful than those in Eastern Europe. The evidence from China is compelling, demonstrating that the Eastern European experience is not universal.

The second conclusion, based on the Chinese experience of the last five years, is that system change from a planned system to a market system can occur without a political revolution. The Eastern European reform in the 1970s and 1980s led to a dead end because "the system is incapable of stepping away from its own shadow" (Kornai, 1992). It eventually resulted in a political revolution that jump-started the transition in the 1990s. Although it is still too early to predict that China can successfully complete its transition to a market system, there is enough evidence to show that the goal is set, the journey is well under way, and the chance for attaining the goal is good. Therefore, the previous conclusion based on the Eastern European experience that planned economies are unable to replace their systems with market systems needs to be reconsidered. If China completes its transition, it will be the first country under the Communist Party to do so.

The third conclusion, based on China's two decades of reform, is that there are diverse paths for a successful transition. A good path of transition, especially concerning institutional changes, has to consider country-specific conditions. China provides a case of a feasible and successful alternative path of transition to markets, in which no political revolution predated the change of economic systems as was the case in Eastern Europe. Hence, the assumption that all planned economies were alike and that they should follow the same path of transition needs to be modified.

China's case shows that reforming a socialist economy can be successful; the planned system can evolve smoothly to a market system; and there are diverse paths for making a good transition. It may be argued that China is special because it was a poor agricultural country. It may also be argued that Hungary and Poland are special because their early reforms were constrained by not being truly independent from the Soviet Union, and their later transitions were facilitated by their aspirations to join the European Union. In any event, the principles of system changes are more complicated than one used to believe.

B. Reflections on the Process of Reform

After twenty years of experience, China's reform can contribute several lessons about the process of reform in particular and institutional change in general. The main lesson is that considerable growth is possible with sensible but not perfect institutions, and some "transitional institutions" can be more effective than the "best practice institutions" for a period of time because of the second-best principle: removing one distortion may be counter-productive in the presence of another distortion.

In transition economies basic market-supporting institutions (such as the rule of law) are lacking, as well as the people and human capital to operate them (such as law enforcement). Both usually take years to develop, except in the case of East Germany, which was absorbed into West Germany immediately after unification. This often means that the international best practice institutions, even if we know what they are, may not work well for the time being. It also means that some existing institutions can be useful to market-oriented reform even though they may eventually vanish. Fiscal contracting, TVEs, and anonymous banking are all institutional innovations that worked quite well for a time period in the Chinese environment.

All transition economies have great potential for improvement because of enormous allocative distortions and the lack of incentives of the planning system. Therefore, in theory, even if institutions are highly imperfect, impressive results are potentially possible. However, many failures in the early reforms and the recent transition suggest that not all changes can produce good results. What kinds of changes can produce good results? China's experience offers three specific lessons, but they are better viewed as general principles than a formula for transition.

First, institutional changes that create incentives, impose hard budget constraints, and introduce competition should not only apply to firms but also to governments. Indeed, reforming government is an important component of economic reform. When the government is provided with positive incentives and is subjected to hard budget constraints and competition (such as the township and village government), the outcome of the reform is productive; if the government is subjected to softer budget constraints (such as higher level local governments were in the 1980s), the outcome will be problematic.

Second, successful reform relies on political support, which in turn depends on delivering tangible

benefits to a large majority of the population. Economists usually blame "stupid politics" when their beautifully designed reform programs are not implemented. But political scientist Barry Weingast has this to say: "An ironic aspect of the economists' position is that they want individuals to pursue self-interest in markets but not in politics." Compensating potential losers in the reform is both a political and economic issue, and a reform that does not create many or big losers can be politically acceptable *ex ante* and sustainable *ex post*. The dual-track approach to market liberalization, when appropriately implemented, is one example of good politics and economics.

Third, successful institutional change requires appropriate, but not necessarily optimal, sequencing. Unlike macroeconomic stabilization policy, institutional change is an unavoidably long process. Judging from the outcome, the process of China's transition to markets has been fairly fast overall. It took Hungary 30 years and Poland 20 years to achieve their current results and will certainly take Russia even longer. The Chinese experience shows that whenever politically feasible, it is better to dismantle the existing institutions after the new ones are put in place, or allow the new ones to emerge from the old, to avoid an institutional vacuum. It also shows that the implementation of reform can be compatible with the institutional capacity of the economy. Examples of appropriate reform sequencing in China include: Empowering local governments for development of local government enterprises before privatization can be instrumental for growth; pursuing industrial liberalization first while delaying financial liberalization can compensate for fiscal decline, avoid financial crashes, and, at the same time, create better incentives; enforcing a plan track and phasing it out later can minimize the opposition to reform while it improves economic efficiency.

On the other hand, the Chinese experience shows that one does not need optimal sequencing to achieve an impressive performance, and what is most important is to avoid fatal mistakes rather than to make fine tuning. Indeed, many arguments can be made that China's reform is not optimal. Both in terms of reform sequencing and of any specific reform, arguably, China could have done a better job and achieved even greater results if better alternative reforms had been done. The errors made with the "crossing the river by touching the stones" style can be detected. For example, as I have shown above, China's reform fell short in the areas of reforming the financial system and large state-owned enterprise and establishing of the rule of law.

However, to this date, these errors have not undermined China's reform in a fatal way.

C. Reflections on the Theory and Practice of Transition

Transition from a planned to a market economy is one of the most significant economic events of the twentieth century. The core of the transition concerns institutional transformation, which is complicated and difficult. For most transition countries, with the exception of few, transition will take more time to complete. During the past decade there were two big surprises. One big surprise was the sharp initial decline in output followed by recovery in most countries of Eastern Europe and the former Soviet Union -- the phenomenon known as the U-shaped output response (Blanchard, 1997). Another big surprise was China's remarkable success on its different path of transition.

The gap between conventional economic thinking and the realities of the transition shows that our knowledge about institutional change in general and transition in particular is quite limited. This limitation has two related components. First, our knowledge about how a capitalist market economy works is still limited. Although neoclassical economics is a powerful tool for explaining how price mechanisms work, it does not provide complete theories about the role of institutions, history, and political economy yet. Ronald Coase (1992), referring to transition economies, says, "without the appropriate institutions no market economy of any significance is possible. If we knew more about our own economy, we would be in a better position to advise them." Unfortunately, we didn't. Douglass North (1997) agreed: "While neo-classical theory is focused on the operation of efficient factor and product markets, few western economists understand the institutional requirements essential to the creation of such markets since they simply take them for granted. A set of political and economic institutions that provides low-cost transacting and credible commitment makes possible the efficient factor and product markets underlying economic growth." To build a market system from scratch, nothing can be taken for granted.

Second, our knowledge about the transition process is even more limited. There is a difference between the final destination and the process of transition, and even if we have perfect knowledge about the destination, how to get there is a separate issue. As Robert Solow said, "There is not some glorious theoretical synthesis

of capitalism that you can write down in a book and follow. You have to grope your way" (*The New York Times*, September 29, 1992, p. E1). Richard Freeman (1994) echoed that view, "economics does not have sufficiently compelling theory or empirical knowledge to answer questions about the institutional design of advanced capitalist economies, much less economies in transition."

Because the transition from plan to market is unprecedented, the practice of transition is original and the theory of transition is in its infancy. Two excellent survey papers on the economics of transition (Dewartripont and Roland, 1996; McMillan, 1996) all recognized the limits of our knowledge on transition. More and more people, both inside and outside the transition economies, have realized this too. Even Anatoly Chubais, one of the leading architects of Russian reform, acknowledged after the Russian crisis in 1998: "We must recognize that we did not fully understand the scale of the process which we had undertaken. We thought there would be a very difficult three years, five years, eight years. Now, unfortunately, it is clear that reform will take decades" (Reuters, September 24, 1998).

China's reform path was not designed at the outset, but evolved. Rather than being naive or cynical about reform, Deng Xiaoping and the Chinese reformers were pragmatic, recognizing from the beginning that they didn't know what would make the reforms succeed. Studying China's experience should add a lot to economics as a social science of human beings. After all, this country has nearly one-fifth of the world's population and has the possibility of becoming, once again, the largest economy in the world in less than two decades (Maddison, 1998).

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