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# China's Reforms: Past, Present and Future

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## **1. Introduction**

The transition of countries with centrally planned economies to a market orientation, which affects about one-third of the world's population, has been an unavoidable reality in recent years. The world and U.S. have a large scale stake in the former Eastern Bloc countries and China whether they will continue to be politically stable and their economy stays prosperous or not. This is why the reforms undertaken in these countries have attracted the attention of many scholars.

Roughly speaking, there are two approaches have been used among countries in the transition. One is the 'big bang' approach and the other is the gradual reform approach. These two approaches have resulted in quite different outcomes. While most of the former Eastern Bloc countries are attempting their transitions by massive privatization and these counties with rapid privatization have not been without serious problems, China has quietly been making the same transition, but in comparison, its road has been relatively smooth.

In this note, I will mainly focus on China's reform and institutional transition. The note is organized as follows. In section II, I will view and evaluate the achievements of China's liberalization and marketization reforms and institutional transition.\* In Section III, I will give a rationale for China's partial and gradual reforms and answer why China's transition is relatively successful. In Section IV, I will discuss difficulties and problems to be solved in China's transition. Concluding remarks on perspectives of China's institutional transition will be given in Section V.

## **2. Achievements of China's Economic Reforms and Institutional Transition**

As people in the whole world have witnessed, China is now experiencing a

radical transition from backward society to an economic power. China's market-oriented economic reform that began from agriculture in 1978 has achieved great success in terms of economic performance and reforming the economic institution. China has surprised the world with its rapidly economic growth throughout the 1980's and 1990's. The average annual growth rate of GNP was 9.5 percent from 1978 to 1998, which made China the fastest growing economy in the world. The transition is also relatively stable and smooth. Inflation rate is much lower than those countries with rapid privatization. From Tables 1 and 2, one can see that the countries with massive privatization (groups 2 and 3 in the table) have experienced significant declines in output and high inflation while China and Vietnam without massive privatization so far have enjoyed rapid economic growth and much lower inflation since their transition.

China has also made great progress in reforming the economic institution. Through economic liberalization and marketization reforms, many new non-state owned firms (including collective enterprises, private enterprises, township-village enterprises (TVEs), foreign capital funded enterprises, and joint ventures) entered into the economy to compete with existing state owned firms. This made Chinese economy changed from a state dominated economy to a non-state dominated economy. State-owned sector share of the total GNP has been dropping drastically. In 1978, about 80% of GNP was produced by the state-owned sector and came down to about 30% by the end of 1997. With the average annual growth rate over 20%, the non-state owned sector has become the main driving force behind the rapid economic growth in China. What is interesting is that collectively-owned enterprises comprise 74% of this sector, and these enterprises do not enjoy clearly defined property rights.

In addition, China has made remarkable progress in liberalizing the economy and building up various market-supporting institutions. Now people have much more economic freedom in economic activities. The prices of most of commodities are free and determined by market forces. The labor market, financial institution, legal system, and social security system have been introduced and developed quickly. The liberalization and marketization reforms will speed up the process of transition. All of these achievements indicate that China's transition to a market economy has so far, been quite successful both in terms of rapid economic growth and smooth institution transition.

### **3. Why does China's Gradual Reform Work?**

Why are China's reforms relatively successful, compared to the former Eastern Bloc countries? What the procedure, timing, and relations of liberalization, marketization, and privatization should be for a smooth transition? In my view, a

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smooth institutional transition to a market economy should go through three stages: (1) economic liberalization; (2) marketization; and (3) privatization. In the first stage, the entry and competition of enterprises of all kinds of ownerships make the non-state owned sector develop rapidly. In the second stage, competition among enterprises of all kinds of ownership and the introduction and development of various market-supporting institutions lead to reduction of state-owned enterprises. In the third stage, state-owned enterprises will face large scale bankruptcy and privatization. This three-stage transition method is consistent with the available evidence on transition processes in China and some other countries. As for China, the first stage began with rural economic reform in 1979. The second stage began in 1992-3, marked by the resolution on marketization by the 14th National Congress of the Chinese Communist Party. The third stage just begins, marked by the resolution on speeding up reforming state-owned firms by the 15th National Congress of the Chinese Communist Party, although, in my view, it may be preferable to wait about 3-5 years until the non-state owned economy has become a large proportion of the economy, say above 80% of GNP, and the social security network is almost completed.

A theoretical model developed recently by myself has offered a rationale for such a way of transition. The theory argues that property rights or ownership should be endogenous and are functions of the varying degree of liberalization and marketization. It shows that the most suitable ownership structure may be different under different economic environments. It argues that when economic freedom is very limited and the market is imperfect, the SOEs may have relatively more advantage over collective- and private-owned enterprises; when the market economy develops to an interim stage, the collective-owned enterprises may have more advantages than the other two forms of ownership; and when the market economy develops to its mature stage, private ownership is the best ownership structure. The result shows that a private ownership arrangement may not be appropriately established without reducing government intervention in production activities, and without improving economic freedom and market environments. Thus, an unconditional mass privatization of state-owned firms may not be appropriate for an institutional transition.

It should be emphasized that the result should not be interpreted to argue the advantage of state and collective ownership arrangements. Rather, they should be used to argue the fundamental importance of economic freedom, decentralized decision making, and marketization, and consequently the importance of improving economic environments. To reach the efficient allocations of resources, one nevertheless should adopt private ownership as the final goal. However, the

procedure for reaching such a goal should not privatize state-owned firms rapidly, but should be to first improve economic environments through liberalization and marketization reforms. Liberalization and marketization can not only bring the entry of many new firms into business, but also change the institutional environments to ones which are suitable for private ownership arrangements.

#### **4. Difficulties and Problems to be Solved in China's Transition**

Although the above mentioned achievements, with the deeper development of reform and the acceleration of the transition process, many problems remain to be solved. The most noticeable problem is of course the poor performance and losses incurred by state-owned enterprises (SOEs). The grave situation of the SOEs has manifested itself in the following ways.

(1) **Losses by SOEs.** The number of loss-making SOEs and the amount of the losses have been increasing continuously. About two thirds of the SOEs are operating at losses now. When the SOEs are measured as a whole, the amount of their total losses has exceeded their total profits.

(2) **Low efficiency.** The contribution by the SOEs to the national industrial growth becomes smaller and smaller. At present time, the SOEs only contribute about 5 percent to the total industrial growth in China, while the non-state sector contributes about 95 percent. The SOEs as a whole are so inefficient that they produce about 30 percent of the GDP using about 70 percent of the total capital formation.

(3) **Huge deficits.** The SOEs have caused huge deficits in the government budget. It has become increasingly difficult for the government to bear the burden of billions of dollars every year to subsidize the loss-making SOEs, whose number has been rising continuously. This may result in the financial crises such as those recently happened in some of the South East Asian Countries.

(4) **Decrease in living standard of workers.** The living standard of workers employed by the SOEs has been dropping in recent years. Many loss-making SOEs now can only pay workers the basic wage without any other benefit, while some are in such bad shape that they can not even pay the basic wage. This has resulted in many workers living under the poverty line, especially those employed by the SOEs whose production has been idle or semi-idle.

(5) **Inability for supporting unemployed workers and retirees.** The government does not have the enough required financial resources to support millions of workers who are going to be laid off. Even without reorganization and bankruptcy, the government needs to provide assistance to more than 50 million

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people, 13 million of which are workers who are in essence already laid-off by the loss-making SOEs, 7 million of which are waiting for employment, and 30 million retirees.

(6) **Widespread erosion of state-owned property.** Because the market economy in China is still in its primitive stage and government regulations are inadequate, state-owned property has been eroded at marked speed. According to some surveys, on average about 100 million yuan (about 12.5 million dollars) of state-owned property have disappeared per day since 1980, which has put the total number to about 1 trillion yuan (125 million dollars) by now.

Because of the serious problem of SOEs in China, the recently convened 15th National Congress of the Chinese Communist Party (CCP) has announced that the reform of China's state-owned enterprises (SOEs) will be the top priority for the current economic reform. One major policy measure proposed by the Party Congress on SOEs reform is 'control the big, while release the small', and a major direction for state-owned enterprises' reform is to adopt the stock share-holding system. The so-called 'control the big, while release the small' means that the government wants to control about 1000 large-sized SOEs, while at the same time quicken the pace in relaxing the control over small-to medium sized SOEs and invigorating them by way of leasing, contract operation, stock share-holding or sell-off.

Then a question is: What kind of the stock sharing-holding system should be adopted: should be the one that the state or the collective dominates the sharing holdings or individual shareholders dominate the share-holdings? The Chinese government seems to favor the former -- the share-holding in which the state or collective dominates the individual holdings from the report of Jiang Zemin. Such proposal still has not broken the ideological worries. The CCP seems to still believe that it is possible to run public economy efficiently under market conditions. Such a belief, however, cannot be supported by either economic theory or practice.

A stock share-holding system has two main functions. First, it can promote the development of an efficient capital market. Second, it can objectively appraise the economic performance of an enterprise, while a supervising government branch usually can not. The information regarding an enterprise will be more reliably reflected in the stock prices by the trading in the stock market. If a firm performs well, its stock price is likely to go up, for more people are willing to buy and hold its stock. Through the trading of the stocks, the efficient firms will survive, while the inefficient ones will go out of business. If the state or collective holds the controlling share, directors and managers of an enterprise are appointed by the upper administration departments, while smaller shareholders can not really participate.

Since these appointed factory directors and managers don't bear the risks associated with their management, they are less likely to devote all their efforts to increasing the value of the firms. In a market economy, it is difficult for them to compete with those firms where individual shareholders hold the controlling share and bear the risks of the firms.

Besides the problem of SOEs, many other problems need to be solved. For example, the primitive nature of the current market system; the mature financial market system and social security system have not established yet. The imperfection or nonexistence of laws and regulations governing labor markets, financial markets, property rights protection, and social security and welfare systems. Corruptions becomes more and more serious. In addition, the political reform has not begun yet and China is now facing cultural crisis and the reestablishment of values in my view. The evidence is demonstrated by money worship, moral vacuum, social dislocation, etc. How can China inherit its Eastern heritage while incorporating the elements from Western civilization? If these problems are not solved, they will affect China's smooth socio-economic transition to a modern society with economic freedom, political democracy, social civilization, and cultural pluralism.

## **5. Conclusion**

In this note, I view and evaluate China's reforms and institutional transition. I gave the rationale for China's gradual reform. I also discuss the difficulties and problems to be solved by China.

Finally, let me end my talk by concluding my view of China's reforms. Although the above mentioned problems and difficulties in China's transition, I am still quite encouraged by the current development in China. It is a very promising sign for China to establish a market economy. I think the private sector will play a more dominant role in China's economy in future. When the people have a better standard of living, they will want to protect their private interests. The economy has to be the foundation of political change. China will play a more and more important role in world because of its economic and political power as well as its potential huge market.

**Table 1: Growth of GDP in Some Transitional Economies  
(in percentage terms)**

| Countries  | 1971-80<br>(average<br>annual) | 1981-89<br>(average<br>annual) | 1990  | 1991  | 1992  | 1993  | 1994  | 1995  | 1990-95<br>(total) |
|------------|--------------------------------|--------------------------------|-------|-------|-------|-------|-------|-------|--------------------|
| China      | 5.5                            | 11.1                           | 3.9   | 8.0   | 13.6  | 13.4  | 11.8  | 10.2  | 78.1               |
| Vietnam    | ..                             | 4.4                            | 4.5   | 6.0   | 8.6   | 8.1   | 8.6   | 9.5   | 54.6               |
| Mongolia   | ..                             | 5.7                            | -2.0  | -9.9  | -7.6  | -1.3  | 3.3   | 6.3   | -11.6              |
| Russia     | 6.5                            | 3.0                            | -3.6  | -5.0  | -14.5 | -8.7  | -12.6 | -4.0  | -40.0              |
| Georgia    | 6.8                            | 1.2                            | -14.8 | -20.1 | -40.3 | -31.6 | -28.2 | -5.0  | -81.0              |
| Tajikistan | 4.9                            | 3.3                            | -2.4  | -8.7  | -30.0 | -27.6 | -15.0 | -12.0 | -66.2              |
| Ukraine    | ..                             | ..                             | -3.8  | -12.0 | -12.5 | -7.2  | -24.3 | -12.0 | -54.2              |
| Lithuania  | 4.6                            | 1.8                            | -3.3  | -13.1 | -39.3 | -16.2 | 2.0   | 3.0   | -55.1              |
| Bulgaria   | ..                             | 4.9                            | -9.1  | -11.7 | -6.0  | -4.2  | 0.0   | 3.0   | -25.6              |
| Czech      | ..                             | 1.8                            | -1.2  | -14.2 | -6.4  | -0.5  | 2.6   | 5.0   | -14.9              |
| Hungary    | 4.6                            | 1.8                            | -2.5  | -7.7  | -4.3  | -2.3  | 2.5   | 2.0   | -12.0              |
| Poland     | ..                             | 2.6                            | -11.6 | -7.0  | 2.6   | 3.8   | 5.5   | 7.0   | -1.2               |
| Romania    | 7.6                            | 1.0                            | -5.6  | -12.9 | -13.8 | 1.3   | 2.4   | 7.0   | -21.3              |

Source: Table A.2 Indicators of economic growth, *From Plan to Market*,  
World Development Report 1996, World Bank, p. 173.

.. Information not available.



**Table 2: Average Annual Inflation Rate in Some Transitional Economies(percent)**

| Countries  | 1990  | 1991  | 1992    | 1993    | 1994     | 1995  |
|------------|-------|-------|---------|---------|----------|-------|
| China      | 1.6   | 3.0   | 5.4     | 13.0    | 21.7     | 17.0  |
| Vietnam    | 67.5  | 67.6  | 17.5    | 5.2     | 8.0      | 17.0  |
| Mongolia   | 0.00  | 208.6 | 321.0   | 183.5   | 145.0    | 75.0  |
| Russia     | 5.6   | 92.7  | 1,353.0 | 896.0   | 303.0    | 190.0 |
| Georgia    | 3.3   | 78.5  | 913.0   | 3,126.0 | 18,000.0 | 160.0 |
| Tajikistan | 4.0   | 111.6 | 1,157.0 | 2,195.0 | 452.0    | 635.0 |
| Ukraine    | 4.0   | 91.2  | 1,210.0 | 4,735.0 | 842.0    | 375   |
| Lithuania  | 8.4   | 224.7 | 1,020.3 | 390.2   | 72.0     | 35.0  |
| Bulgaria   | 22.0  | 333.5 | 82.0    | 72.8    | 89.0     | 62.0  |
| Czech      | 10.8  | 56.7  | 11.1    | 20.8    | 10.2     | 9.1   |
| Hungary    | 29.0  | 34.2  | 22.9    | 22.5    | 19.0     | 28.2  |
| Poland     | 586.0 | 70.3  | 43.0    | 35.3    | 32.2     | 27.8  |
| Romania    | 5.1   | 174.5 | 210.9   | 256.0   | 131.0    | 32.3  |

Source: Table A.3 Inflation, *From Plan to Market*, World Development Report 1996, World Bank, p. 174.

**\*Note:** *Economic liberalization* means the loosening or elimination of government restrictions on the economic transactions, including freeing prices, trade, and entry of various types of new firms. *Marketization* means the developing and creating market-supporting institutions such as legal, financial, social welfare security system. *Privatization* means the privatization of existing state owned or collective owned enterprises, land, and other assets.