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Were the Chinese reforms a feasible alternative for transition economies?

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Abstract

Purpose – To examine China's reforms and successes could have been replicated to other transition economies.

Design/methodology/approach – The applicability of the Chinese process as an alternative for transition economies involves an analysis of the necessary reforms regarding price liberalisation-stabilisation; privatisation; institutions; monetary policy and the financial system; fiscal policy; international trade and foreign aid and social policy.

Findings – The transition process in China has maintained political-ideological authoritarianism and state control of the whole economy. Therefore, it was not the "special initial conditions" of China that made the model inappropriate but, rather, the switch to a democratic political-ideological-economic structure in transition economies.

Originality/value – The paper contributes to the transition literature by demonstrating that the strategy was only rendered workable in China, as the governments of transition economies neither had the mandate nor wanted to reimpose tight state direction of the politics, ideology and economy.

Keywords China, Transition management, Political systems

Paper type General review

1. Introduction

It has been widely accepted that the Chinese reforms have been successful. Consequently, the experiences and outcomes of the various transition economies, which implemented different strategies, are baffling. Why is it that shock therapy, which dismantled an inefficient economic structure in one shot, resulted in a large decline in economic growth in Central Eastern Europe and the former Soviet Union (CEEFSU), while in China, which initially preserved the inefficient planning system, a substantial increase in output was and is the end result?

Nevertheless, whether China's reforms and successes could have been replicated to other transition economies was hotly debated. McKinnon (1993b), McMillan and Naughton (1992) and Blackburn (1991) argued that China's success demonstrated the superiority of an evolutionary, experimental and bottom-up reform over the comprehensive and top-down shock therapy approach. Not surprisingly, a number of Russians expressed interest in experimenting with the Chinese model (Johnson, 1994, p. 66). Woo (1994), Sachs and Woo (1994), Qian and Xu (1993), Lin *et al.* (1996, p. 201), Gordon (1992, p. 54), Li (1999, p. 133) and Johnson (1994, p. 67) argued that the success of the Chinese reforms was due to neither gradualism nor to experimentation but, rather, to China's unique initial conditions. It was argued that the Chinese reforms

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did not have any implications for other transition economies that faced different initial conditions. Thus "the recommendation that Russia should take the same path as China amounts to telling apples to be pears" (Aslund, 1993, p. 99). Nevertheless, the economic problems in pre-reform China were common to all centrally administered economies and so the Chinese model of transition could had held some interest to CEEFSU, if the Chinese transition process had resulted in the establishment of a market capitalist system. The transition economies of CEEFSU were not interested in adopting a market socialist model, even if it was Chinese-style. Actually, this appears to be true. The dynamic process of reform in China reveals the unfolding of market capitalism, not market socialism. It is in this context that an investigation of the applicability of the Chinese process of reform as an alternative model of transition can take place.

In order to better understand the Chinese model of transition and to determine whether it was appropriate for the transition economies, an exposition is required of the Chinese reforms with regard to: price liberalisation-stabilisation; privatisation; institutions; monetary policy and the financial system; fiscal policy; international trade and social policy. It is important to note that the Chinese experience as a model of transition could only had been relevant during the transition decade of the 1990s and such the knowledge and sources of the Chinese transition is restricted during the same time framework. In the following, I analyse the Chinese reforms of transition.

2. The Chinese process of reform

2.1 Price liberalisation-stabilisation

By 1984, the Chinese government had become convinced of the necessity of a price reform. China was forced to move away from administrative means of controlling prices towards market instruments, as the administrative measures were inefficient in an increasingly liberalised financial setting. However, its approach to price liberalisation was to give social stability a high priority, and the maintenance of social cohesion was a key criterion by which price reform was to be implemented. It was decided to reform the structure of relative prices only gradually and to do so in a controlled and planned fashion, recognising that price controls were necessary.

The mechanism chosen and implemented in May 1984 was the two-track system. Under this system, there were centrally specified input and output quotas, within which sales and purchases were centrally directed at low prices, which were controlled. Above these quotas, and for production sectors for which did not have quotas, firms producing outputs and inputs were allowed to set prices for their products according to market conditions. This formally established the double-track price system: the co-existence of centrally determined prices and market-determined prices.

The establishment of the dual price system preserved planned allocation while incrementally drawing output into the market system and softening the risk of economic reform. By "changing a big earthquake into several tremors", price reform was implemented (Chen *et al.*, 1992, pp. 208-9). The incremental aspect of the dual-track system also allowed for the tandem implementation of price and enterprise reforms. The emergence of a market economy did not mean the immediate collapse of all components of the existing system (Jin and Haynes, 1997, p. 83). The granting of partial micro-autonomy represented a small crack in the traditional economic system.

However, partial autonomy also implied that entrepreneurs gained partial control over the allocation of the newly-created stream of resources. The unexpected result of the micro-management reform was the rapid creation of new enterprises in the market track by autonomous entrepreneurs, driven by profit motivation, allocating the new stream of resources to the previously suppressed sectors. It improved incentives in the state enterprises and collective farms, so that a closer link between personal rewards and individual efforts was established without privatisation (Lau *et al.*, 2000, p. 140; Lin *et al.*, 1996, p. 222). Meanwhile, since the planned allocation mechanism and distorted macroeconomic environment was preserved, the state still had control over the old stream of resources and guaranteed that those resources were allocated to the priority sectors.

Consequently, the aim of the dual-track price system was to reduce the marginal price distortion in the state enterprises' production decisions while leaving the state a measure of control over material allocation (Lin *et al.*, 1996, p. 217). Nonetheless, if the growth rate of the new sector is higher than that of the old sector, then the old sector will continually decline as a proportion of the economy, without explicit reform actions being taken against the old sector (Cao *et al.*, 1997, p. 33). "China is growing out of plan" (McMillan and Naughton, 1992, p. 133). The expansion of the suppressed sectors would not have resulted in a decline in the priority sectors because a new stream of resources supported the expansion of the suppressed sectors. Because the Chinese reform preserved the centralised organisation of production but allowed the emergence of product markets, it led to a general expansion of output in state industry as well (Li, 1999, p. 121). Thus, instead of abandoning planning, China introduced markets at the margin, parallel to planning, establishing an example of outstanding good planning.

Chinese economic reforms, not only price reform, had been progressing through a dual-track system. The dual-track system was also used in most of the other reform areas (Jin and Haynes, 1997, p. 89). The dual structure of ownership, while keeping state ownership relatively unchanged, meant that non-state sectors were encouraged to grow. The dual governance of the market and the plan included a dual-track pricing system, a dual exchange rate system and dual geographical divisions, with the establishment of special economic zones. The dual fiscal division of responsibilities and incentives was represented by a system of revenue-sharing contracts between different levels of government.

The dual price system is, of course, not ideal. There was a paradox associated with the dual-track price reform process. The intention of the dual-track system was to reduce administrative intervention in the economy; however, in order to maintain orderly operation of the dual-track system, more government intervention capable of enforcing the quotas was required. Thus the double-track system perpetuated government control and price distortions (Fan, 1994, p. 145; Li, 1999, p. 133). This provided strong incentives to engage in various sorts of malpractice, including failure to meet quota obligations, disguised price increases for quota sales and the diversion of quota allocations to the market. Most importantly, the dual-track approach initiated a buy-out process of the vested interests, on the one hand, and institutionalised state opportunism and corruption, on the other. Hence China's economic reforms were hijacked by state opportunism and corruption, which promoted the interests of the ruling elite at a cost to society. While the dual-track pricing system is a temporary expedient to smooth the reform process, McMillan and Naughton (1992, p. 137) and Fan (1994, p. 154) argued that it was about time for its abolishment.

Inflation, as experience demonstrated, was an inevitable phenomenon when a country transforms from a centrally planned to a market economy. However, China's other big advantage, in 1978, was that that it began the reform with no overt inflation and not much repressed inflationary pressure (Perkins, 1994, p. 25). During the reform period, the government was not prepared to sacrifice growth to pursue zero inflation. However, it was equally concerned not to allow the rate of inflation to rise to a level sufficient to threaten social stability and to divert investment into speculation away from investment in physical assets. Thus the aim was to keep macroeconomic stability, with low and tolerable inflation. The result was a pattern of fluctuating growth, with the government prepared to intervene sharply to lower inflation, primarily through direct controls on government expenditure, once the rate crossed a critical threshold. The state's ability to control the inflation rate depended both on the effectiveness of the state's apparatus in raising revenue, and its capacity to resist interest group pressure for inflationary increases in state expenditure (Nolan, 1995, p. 226). The partial reform in the large-scale state enterprise sector and the banking system account for the inflation and the stop-go nature of Chinese growth in the period 1988 to 1993, while inflation reached low double digits only during 1985, 1988 and 1989 (Perkins, 1994, p. 43). Consequently, although inflation has been curtailed, its underlying structural causes remained fundamentally unaltered.

Once the Third Plenum of the Eleventh Party Congress initiated reform in late 1978, the responsiveness, capabilities and flexibility of lower levels of government were critical for success: the close and intimate knowledge of the local economy, command over the machinery of political mobilisation, and the organisational resources to implement policies proved to be instrumental for economic growth. Reform was to be based on local experimentation and orchestrated by local political machines, which minimised political risks for the central government and the danger of poorly-conceived actions being widely applied. A decentralized "bottom-up" approach to reform was adopted. Dependence on vertical connections with government officials was replaced by greater reliance on social networks linking actors within and across communities. For that reason, the maintenance of a strong, relatively unified Communist Party was critical to combining cautious and controlled decentralisation with some form of overall control (Johnson, 1994, pp. 68-9, 71; Nolan, 1995, p. 177). A strong central government was able to keep order, maintain movement in the chosen direction and hold the several regions together. Decentralisation in China has involved the devolution of administrative and fiscal power from the state to provincial and local governments and to state-owned enterprises.

As a result decentralisation, alongside the gradual growth of a market economy, produced a desire to promote the local economy, comparable to that of the nation-state. Consequently, it appears that the central government was no longer as powerful as it was in the past. Thus the basic question over China's future revolves around the degree to which the central authority will give way to the increasingly dynamic periphery.

2.2 Privatisation

In CEEFSU, privatisation emerged as a radical strategy to counteract the problems that haunted centrally administered economies, such as bureaucracy, lack of enthusiasm and initiative, and inefficiency. Meanwhile, the Chinese reformers argued, and disaggregated data actually showed, that ownership was entirely irrelevant to the day-to-day operations of the enterprise (Smith, 1993, p. 58). The Chinese experience of transition demonstrated that state ownership had remained a critical actor in the transition process. China rejected the privatisation approach followed by CEEFSU. While the Russians rapidly and criminally privatised state enterprises right at the start of reform process, the Chinese have, so far, maintained state ownership, management and planning for the bulk of the industrial economy (Holmstrom and Smith, 2000, p. 11). China's experience of industrial reform suggested that economists tended to overstate the importance of early privatisation programs during the transition process.

China's success demonstrated the continued economic relevance of social ownership: markets do not require private ownership to function. It was argued that privatisation of the state sector is always necessary but immediate privatisation was not. Privatisation would have been more feasible and smoother after a large non-state sector emerged. Much of China's gains have been due to "pseudo-privatisation" of rural land and of rural industry to "owners" who were not always private, such as township and village enterprises (TVEs), and did not enjoy all the attributes of ownership; however, they have faced incentives similar to private owners. Overall, China has pursued a pragmatic approach with regard to ownership, not an ideological one.

The Chinese reformers chose to deal first with their biggest economic problem, agriculture, partly because it was the easiest political route to take. It was much easier to assign autonomy to the individual plots that farmers were working on. Furthermore, Chinese agriculture was easier to reform than Russian agriculture because of the big difference in labour intensity (Woo, 1994, p. 282). China started with agricultural reform by breaking up the large collective farms into smaller, more efficient, units and introducing the household responsibility system. Under the household responsibility system peasant households were the basic units of farm production. The village collective, on the other hand, takes charge of managing land contracts, maintaining irrigation systems and providing peasants with equitable access to farm inputs, technology, information, credit and the services of farm machinery, product processing, marketing, primary education and health care. This new form of village collective organisation overcomes the main drawbacks of the commune system, while preserving the principal merits of economic organisation characterised by public ownership of the means of production. Initially, household contracts for the use of the land lasted for 15 years, then were extended to 30 years, and now have, for all practical purposes, been made indefinite (Perkins, 1994, p. 26); hence it virtually amounts to individual ownership. Up to now, Chinese reformers have not contemplated the formal privatisation of land.

The most significant change in the structure of the Chinese economy has been the rise in the industrial output produced by the collective sector, the TVEs. This sector consists largely of enterprises under the administrative control and ownership of local governments at the township and village levels. TVEs operate under close supervision from the township or village industrial departments, which contribute start-up funds, appoint managers and are intimately involved in major strategic decisions. The growth of TVEs benefited from the success of China's agricultural reforms, which greatly expanded the supply of rural savings, freed millions of workers to seek non-farm employment and boosted rural demand for consumer goods. The non-state sector in China, dominated by TVEs, has been the main engine of industrial growth in the reform period. TVEs were able to satisfy numerous niches in the developing market economy. China's experience demonstrates that the fastest economic improvements in industry can result from creating an environment where new industries can emerge and that privatisation proved to be an unimportant part of the explanation for the accelerated growth.

There is widespread disagreement regarding the effective property structure of the TVEs. This is because TVEs have vaguely defined ownership structures (Weitzman and Xu, 1994, p. 121). On the one hand, there is the argument that TVEs are some kind of "quasi-private" disguised private enterprises. Private firms have registered as collectives to overcome political discrimination: "wearing a red cap" (Gordon, 1992, p. 55; Hornik, 1994, p. 41; Lau, 1999, pp. 62, 64; Weil, 1996, pp. 73-4). On the other hand, there is the argument that a typical TVE is not a private firm, but a genuine collective firm (Blackburn, 1991, p. 139; Bowles and Xiao-Yuan, 1994, p. 59; Smyth, 1999, p. 195; Weitzman and Xu, 1994, p. 123). Independently of the ownership structure of TVEs, Smith (1993, p. 90) and Woo (1997, p. 322) argued that almost certainly these collectively owned industries will undergo a metamorphosis from collective enterprises to capitalist enterprises, or be privatised outright.

The high efficiency and rapid growth of the TVE sector has exerted a deep influence on the state sector in two major respects. Firstly, competition has forced state enterprises to work very hard to avoid making losses. Secondly, instead of being replaced by massive privatisation, as in CEEFSU, the relative role of state enterprises has been gradually reduced as they are out-competed and outgrown by the TVEs, since the state enterprises are less efficient (McMillan and Naughton, 1992, p. 133; Weitzman and Xu, 1994, pp. 122, 130-1). Consequently, in this process of transition there seems to be no need to privatise state-owned enterprises, which may result in the loss of political control. In the 1980s, in an effort to ameliorate the urban employment problem, the state removed many of the restrictions on the urban service sector and, as a result, restaurants, small traders and many personal services prospered (Perkins, 1988, pp. 634-5).

Regulations on "Transforming the Management Mechanisms of State-owned Industrial Enterprises", under the slogan "separation of ownership and control", formalised the autonomy of state-owned enterprises and their responsibilities and the financial consequences of their independent business decisions (Perkins, 1988, p. 642). State firms were allowed to "reject" or "refuse" official instructions, including mandatory plan directives that fell outside narrowly defined boundaries. Overzealous officials who encroached upon enterprise autonomy would "bear responsibility for a criminal act". Enterprises could "select employees according to their merits" and "dismiss and fire workers and staff" (Jefferson and Rawski, 1994, p. 62). Profit is now the main objective in Chinese industry. As a result, China's approach to large state enterprises was first to corporatise them, without privatisation.

There is disagreement with regard to the effectiveness of the attempts to reform the state sector. Naughton (1994, p. 483) and Jefferson and Rawski (1994, p. ii) argued that, due to the reforms introduced, state-owned enterprises had a moderately rapid total factor productivity growth record, which induced efficiency-enhancing responses. Conversely, Sachs and Woo (1994, p. 118), Smith (1993, p. 63), and Cao *et al.* (1997, p. 37) argued that the state sector in China has continued to perform poorly. It makes heavy losses, lags in total factor productivity growth, depends on state subsidies, and apparently is suffused with economic corruption. The inability to make their own decisions in accordance with market conditions resulted in low competitive capacity and weak vitality for growth. The central government continued to prop up much of state-owned industry through low-cost bank loans and other subsidies, perpetuating the syndrome of the soft budget constraint. "In short, the state enterprises were like puppets" (Lin *et al.*, 1996, p. 207). A contradiction regarding the reform has appeared due to increasing managerial authority: the state finds that its own continued ownership and control hinders their independent progress. It has been argued that privatisation and providing a uniformly competitive environment is the solution. Yet to relinquish the last vestiges of government possession is to abandon all pretence of a socialist system (Weil, 1996, p. 32).

Nevertheless, actual privatisation is taking place in China through spontaneous privatisation and "state asset stripping" by local cadres who are often transformed into entrepreneurs. This was the means by which hard-line opponents of reform were given some stake in the new system in order for reform to progress smoothly (Johnson, 1994, p. 72). Meanwhile, the government is quite successful in privatising small and less important businesses, effectively permitting the growth of a sizeable private and semi-private capitalist economy outside the state sector. If present trends continue, Weil (1996, p. 36) and Smith (1993, p. 86) argued that the "collective sector" will gradually merge with the private capitalist sector. It does not thereby follow that a large state sector would be a permanent part of China's market economy (Naughton, 1994, p. 486).

In 1995, China began a reform in privatising and restructuring the state-owned enterprises under the slogan "grasping the large and letting go the small" (Cao *et al.*, 1999, pp. 104-5; Lau, 1999, p. 58). It was announced that 1,000 of the largest state-owned enterprises were to remain under state control and that the 13,000 large and medium-sized state-owned enterprises, as well as most of the 350,000 smaller companies, were to be denationalised. The sale of state enterprises occurs by auctioning or corporate transformation, where most shares are sold to private individuals, or a share-based cooperative system (SBC), where shares are sold mostly to employees (Cao *et al.*, 1999, p. 110; Lau, 1999, p. 58). The all-familiar picture has emerged in China, as with the CEEFSU, where firms were either bought by foreigners or the share distribution favoured managers who have acquired shares from workers who often immediately re-sell their share allocation (Cao *et al.*, 1999, p. 111; Lau, 1999, p. 59). The SBC, with its supposedly "co-operative" features, was obviously a useful formula to disguise de facto privatisation.

The privatisation process has been initiated by local governments and tolerated, sometimes even encouraged, by the central government. It has become in the local government's interest to privatise or restructure state enterprises due to the hard budget constraints of local governments and the increased competition from the non-state sector that has made it increasingly costly to maintain these inefficient enterprises (Cao *et al.*, 1999, p. 121). It has also been a strategic move, as in all elements of the reform process, to assign the responsibility of privatisation to the local governments. Local governments can pursue the reform at a speed suitable to local conditions. The central government does not force local governments to reform all at once or all at one speed. Thus, if the local government found that workers were not being absorbed as fast as predicted, it could slow down the pace of privatisation or lay-offs. This, in part, accounts for the unevenness of privatisation across localities.

2.3 Institutions

The Chinese experience demonstrated that the development of institutional arrangements required specific knowledge of the historic time, region, culture and government, since institutions are public goods. While the development of market institutions was tremendously important, they take time to actually materialise. Owing to the fact that China's reform effort was experimental, based on improving performance rather than establishing a western-style market system, it is not surprising that institutional change has also been gradual, uneven and unfinished. Maintaining, instead of destroying, existing institutions avoided the time-consuming process for individuals to reconstruct their knowledge about the workings of the economy (Nolan, 1995, p. 57). In fact, the dual-track approach used minimal additional information, compared with other possible liberalisation schemes. The dual-track approach utilised the existing information contained in the original plan and enforced the plan through existing institutions. No new information or institutions were required.

To a western-trained economist, the centrality to any transformation process of establishing well-defined private property seemed so self-evident as to hardly merit discussion. Actually, one of the major problems with the CEEFSU transitions concerned the inability to establish well-defined private property rights (Weitzman and Xu, 1994, p. 122). In China, the process of institutional development avoided any collapse in output. Actually, the unusual institutional arrangements in China challenge many popular notions about economic reform. In contrast to property rights theory, the Chinese "ownership maze" demonstrated that while ownership claims are tacitly recognised, property rights in the formal sense are vague, ill-defined and fuzzy (Weitzman and Xu, 1994, p. 131; Yusuf, 1994, p. 76). In the Chinese economy, transparent, legally protected individual property rights were the exception not the rule. Public ownership characterised by confused property rights was the norm (Nolan, 1994, p. 6; Smyth, 1998, p. 236). Most importantly, China's reforms have been successful in stimulating economic growth in spite of their failure to clarify property rights.

In China, institutional development was viewed as a product of simply removing controls. Consequently, the emphasis placed on informal institutions, rather than formal contracts, seemed to be a response to deficiencies in the explicit institutional structure. Therefore, once the integrity of the traditional economic system was cracked by the introduction of enterprise autonomy, institutional changes occurred in a way that was self-propelling. China's path-dependent institutional reforms have followed a path that can be explained by induced rather than designed institutional innovation (Jianguo *et al.*, 2001, p. 103; Lin, 1989, p. 13; Lin *et al.*, 1996, p. 225). Basically, the absence of a well-defined legal framework encouraged implicit inter-firm arrangements. In addition, the absence of well-developed capital markets contributed to the growth of informal rural credit co-operatives. It is clear that informal arrangements are preferable to none at all (Smyth, 1997, p. 248).

The experience of other transition economies suggested that there had to be a significant period of conversion to market tradition before a strong set of formal institutions could evolve. That it would have taken time for a market tradition to be developed is pertinent. Thus introducing formal institutions might not be possible, at least in the shorter term. In a period of transition, such implicit and uncodified property rights and informal institutions had several advantages, depending on the degree of market imperfection and the pattern of market demand (Smyth, 1997, p. 261; Yusuf, 1994, p. 76). Indeed, the need for an explicit legal framework was reduced, because implicit contracts were self-enforcing (Smyth, 1997, p. 243). The TVE enters into informal contracts based on its reputation, which is considered a core asset common to all TVEs. It is the effects of reputation and custom that underpin the functioning of informal institutions. Although obscure, property rights may lead to short-sightedness in investment decisions. Ownership incentives and risk sharing have, so far, outweighed this short-sightedness in investment decisions (Yusuf, 1994, p. 76).

The property rights of TVEs can only be exercised collectively through the representatives of the community. There is no residual claimant in the traditional sense. In fact, 60 per cent or more of the after-tax profits of TVEs cannot legally be distributed directly to the residents, but must be reserved for the TVEs. Most of this reserve fund is re-invested, with the remainder used as a collective welfare fund, since it is intended for social purposes (Weitzman and Xu, 1994, pp. 121, 133). A transformation strategy centred on custom and vaguely defined cooperatives, even with a hard budget constraint, would seem the farthest thing imaginable from the conventional wisdom of property rights theory (Li, 1996, p. 2; Smyth, 1998, p. 235; Weitzman and Xu, 1994, p. 136). However, due to this bizarre institutional structure, the dynamism of the economy came mainly from the swift entry of new, small, non-state enterprises. Implicitly, the Chinese reformers followed Hayek (1986), who argued that efficient institutional arrangements could only emerge through a spontaneous process, as the unintended consequence of interactions between self-interested actors. Consequently, informal institutions might be more efficient than formal institutions.

Nevertheless, so far two questions have not been addressed: under what circumstances might informal institutions be more efficient than formal institutions? Why are vaguely defined cooperative TVEs as efficient as private firms? It seems fair to say that standard property rights theory aspires to be universal and culture-free. The theory assumes, explicitly or implicitly, that all people are indiscriminately non-cooperative, regardless of their cultural background. Weitzman and Xu (1994, pp. 136-7, 139) argued that conventional property rights theory might be inadequate because it missed a critical dimension: co-operative culture, the capability or desire to be cooperative. Meanwhile, governance arrangements have a high correlation with historical background and the social, cultural and commercial environment. Corporate governance operates at both the formal and informal regulatory levels, where customs, business culture, ethics, historical background, and social and commercial environments have an important role (Bowles and Xiao-Yuan, 1994, p. 57; Jianguo *et al.*, 2001, p. 96; Smyth, 1997, p. 260; Unger and Cui, 1994, p. 81).

Let the outcome to a repeated non-cooperative prisoner's dilemma game be quantified by the parameter λ, which has a value between zero and one. A high value of λ, close to one, means a non-cooperative solution that resembles the outcome of cooperative collusion. A low value of λ, close to zero, means a non-cooperative solution that differs from the outcome of cooperative collusion. The parameter λ represents the ability of a group of people to resolve prisoner's dilemma and free-riding problems internally, without the imposition of explicit rules of behaviour. With a value one of λ, people in a group would be able to solve the free rider problems internally. With an λ

equal to zero people in a group would not be able to solve the free rider problems. With a λ between zero, and one, people in the group would be able to cooperate effectively, the more so the larger to value of λ.

A lot of anecdotal evidence could be cited to justify the general proposition that East Asia is a high-lambda society relative to Europe, which by comparison is more of a low-lambda society (Weitzman and Xu, 1994, p. 139). Well-defined property rights may not be so crucial in a high-lambda society; an implicit contract may be more efficient than an explicit contract. High-lambda individuals prefer implicit to explicit contracts because there is a saving of time and energy in negotiating, formulating and enforcing the contract and there might be an incentive effect for the implicit contract.

Li (1996, p. 3) explained the usage of informal institutions in China by the fact that the market environment can be characterised as a grey market. A grey market is one in which transactions may be blocked due to government regulations. However, a government bureaucrat can work around the obstacles and make the transaction possible. Thus, the grey market gets it name due to the uncertainty regarding whether the transaction will be "white" or "black", i.e. legal or illegal. Facing a grey market, the entrepreneur has an incentive to include the government as an ambiguous owner. Ambiguous property rights arise when the owner's rights are not guaranteed beforehand. Instead, owners have to fight for actual control *ex post*. Strangely enough, the otherwise private firm is optimally chosen to have an ambiguous owner and property rights. The benefit of ambiguous property rights is that, when the transaction is black, the firm can get help from bureaucrats. In other words, the arrangement of ambiguous property rights is a response to the greyness of the market, which is a form of market imperfection. Hence, by choosing to register the firm as a collective, entrepreneurs intentionally invite the local government to share the rights of control. Once the local government is involved in the operation of the firm, it is difficult to pre-assign control rights and the division of control becomes blurred: control rights are ambiguous (Li, 1996, p. 5).

It has been widely recognised that the reform process in China has resulted in an unacceptable level of corruption and rampant, unregulated and often illicit speculation. Such official corruption reduces the effectiveness of the dual-track system and undermines political support for the reform. Corruption was due to the fact that the maintenance of political stability was an obsession for the reforming government. Political stability required continued commitment to the old political institutions. The maintenance of political stability enabled the state to remain comparatively effective in maintaining reasonably predictable rules. However, corruption effectively diminishes the relative power and advantages of the administrative elite (Nee and Matthews, 1996, p. 407).

It has been suggested that the solution to these unprecedented levels of corruption is the institutionalisation of private property rights, which are secure and transferable (Lin *et al.*, 1996, p. 225; Perkins, 1994, p. 28). In addition, the informal institutional arrangements in the economic system have become internally inconsistent. Informal institutions entail costs, which become more manifest as the non-state sector grows in size and informal avenues are no longer sufficient, requiring the excessive use of direct administrative means. Subsequently, in this context, the reform of property rights in China is more important than immediate privatisation (Bowles and Xiao-Yuan, 1994, p. 51; Jianguo *et al.*, 2001, pp. 94, 106; Nee and Matthews, 1996, p. 417). Increasingly, economic actors can co-ordinate their interests though market institutions and social networks, bypassing the local party organisation to some extent. The question is whether a Communist government, accustomed to political monopoly and unfettered control over economic resources, can create a legal and regulatory framework within which enterprises can further broaden their autonomy and establish institutional guarantees of private property. This would effectively "get rid of the Communists and install a bourgeois state" (Smith, 1993, p. 37).

2.4 Monetary policy and the financial system

The aim of the reforms in the financial sector was to establish and improve the two-tier banking system, where the central bank would focus on supervision and setting monetary targets. However, Chinese reforms have been criticised by orthodox economists because they did not establish an independent central bank and a consciously independent monetary policy (Chen *et al.*, 1992, p. 217; Huang, 1994, p. 71; Yusuf, 1994, p. 90). This is because, in a government-controlled planned economy, China's leadership was alleged to have been printing currency, fuelling a dangerously inflated bubble economy instead of responding to increases in money demand. However, an independent central bank is inconsistent with socialist principles.

The Chinese reformers have also initiated reform in the financial system. Compared to the single-bank system before 1979, there is now a financial system under a central bank, including four big "specialised" commercial banks and several other small universal banks, a far-reaching network of urban and rural credit cooperatives, and hundreds of finance and investment companies. The big four commercial banks in China, established in 1994, are known as the "specialised banks" as each of them specialises in one of the following sectors: industry and commerce, agriculture, construction, foreign trade and international capital flows (Lin *et al.*, 1996, p. 218). The specialised banks finance important projects that may not meet commercial loan standards. The aim of the gradual reform of the financial sector was to avoid the experience of transition economies that permitted unrestricted wildcat banking, which resulted in inflationary explosions (McKinnon, 1993a, p. 81). In China, there was no monetary overhang, which contrasted strongly with CEEFSU.

However, to the orthodox economists' dismay, the independence of China's banking establishment was compromised effectively not only by the central government but also by the local governments. Considering that banks operated under the close supervision of local governments, they were careful to listen to local governments' priorities: acting in the interests of the region was more important than profits. Local governments did not like to see local banks remit excess reserves to the central government or to see banks lend excess reserves to banks in other localities, even to branches of the same bank. "The rule of the game has been to keep deposits with the local boundary" (Chen *et al.*, 1992, p. 217).

A prominent feature of China's financial system was the considerable appetite of enterprises for investment resources, motivated by low, often negative, real interest rates. Turning funding over to banks, however, did not necessarily harden the budget constraint (Perkins, 1988, p. 617). Owing to the existence of distortions in both product and factor markets and the fact that the managers followed government instructions, this provided the state enterprises with legitimate excuses for demanding government subsidies, tax concessions and preferential credits, and made the enforcement of the

Enterprise Bankruptcy Law exceedingly difficult. Consequently, the budget constraint was soft. Effectively, only a handful of enterprises were actually made bankrupt. The difficulties came mainly from the lack of a social security system. It was politically dangerous to displace employees of bankrupted firms onto the job market without unemployment support. Some loss-making industries, such as energy, transportation and infrastructure sectors were considered too important to fail.

Nowadays, stock markets have become "neutral" economic forms utilised by socialism (Lau, 1999, p. 54). The official opening of the Shanghai Securities Exchange and the Shenzhen Stock Exchange in 1990 and 1991 marked the rebirth of the Chinese stock market. However, the stock market cannot be relied on as a device to solve the problems of capital shortage and X-inefficiency in state-owned enterprises. Western experience shows that fast economic growth can be achieved without a developed stock market (He, 1994, p. 214). Although the stock market can provide the advantage of sharing risk and facilitating capital mobility, at the same time the government uses discriminatory tax incentives to encourage firms to become listed in order to promote the development of the stock market. The share market could only have been developed naturally when the demand for its services arose. Therefore, the right approach to the development of a stock market in China was "demand following" rather than "supply-leading" (He, 1994, p. 214). Thus, in the case of China, reforming the present banking system and making it more competitive were far more urgent than setting up stock exchanges.

In this context, there is disagreement between economists about the effectiveness of the monetary and financial reforms. Yusuf (1994, p. 88) argued that China's monetary management was surprisingly effective, while Hornik (1994, p. 31) argued that the Chinese macroeconomy lacked monetary and fiscal discipline. The disagreement stems from the debate about whether the ultimate goal is market socialism or market capitalism. Barratt-Brown (1995, p. 243) and Weil (1996, p. 76) argued that, by 1994, China was moving towards a fully-fledged capital market and private banking system with openings for foreign capital. A foreign exchange market and foreign banks were already operating in China. Even more remarkable, the issuing of shares in former state properties, not only to Chinese residents but also to foreigners, was under consideration. What would be left of socialism in China? What direct power would the government have over the economy when, as was proposed, the Central Bank was made independent? How was this different from a capitalist economy with a government employing the indirect measures at its disposal to influence the decisions of capital-owners, national and foreign, within the overall pressures of the going rate of profit?

2.5 Fiscal policy

While budgetary deficits are frequently associated with inflationary pressures and external imbalances, this did not appear to be the case in China during the process of fiscal decentralisation. Chinese reformers argued that the purpose of fiscal policy should not have been to maintain a mechanical balance between revenues and expenditures, but rather to promote economic growth. Actually, the primary problem of the Chinese economy today is inadequate aggregate demand and under-utilisation of capacity. The present capacity utilisation rate is only around 50 per cent (Chaohua *et al.*, 1999, pp. 85, 89). Under these conditions, an increase in the deficit would help to reduce unemployment, rather than unleash inflation. However, due to the unprecedented level of corruption, public funds were frequently channelled into speculative activities, in which losses accrued to the state and gains were privately pocketed. As direct subsidies have declined, enterprises have become more dependent on financing from banks and financial markets. The very power of credit flows meant that their control has become intensely political. As decentralisation proceeded, the management of credit was determined by political bargaining. Only a fear of the political damage which rampant inflation may have caused enabled the central government to impose some restraint on monetary increases. Effectively, budgetary policy was an exercise in political economy. Without progress in the political sphere, technical solutions would not have worked (Yusuf, 1994, p. 90).

China differs from other countries in that the central government collects very few of its own taxes. Apart form customs duties and selected excises, the central government relies on local government for the collection of tax revenues, most of which originate with state industry. Some portion of tax revenues collected locally was remitted to the centre, as specified by a system of financial responsibility contracts. Under this scheme, local governments remit a fixed target of revenue to the centre. In view of the fact that actual collection of taxes was primarily a local, rather than a central, responsibility, it comes as no surprise to learn that the central government has found itself obliged to bear the brunt of the revenue squeeze. This squeeze resulted from the falling state enterprises' profits, the universal efforts to avoid paying taxes, and the soft budget constraint (Fan, 1994, p. 147; Perkins, 1994, p. 38).

By giving lower-level governments a bigger stake in the prosperity of the local economy, fiscal decentralisation has been crucial in cementing their support for increasingly more difficult reforms. As a consequence, the share of revenue going to the central government has dropped. In 1981, the central government's share of revenue was 57 per cent; by 1993, this had dropped to below 39 per cent. Thus the national state bodies of "socialist" China were greatly under-funded. At the same time, the Chinese budget deficit soared from 2.6 billion Yuan or $US442 million in 1981, to 23.8 billion Yuan or $US4.1 billion in 1992: a tenfold increase. If government debt was included, the figure rises to 90.5 billion Yuan or $US16 billion. This is equal to some 3.8 per cent of GNP. This massive loss of revenue has fuelled the almost desperate drive to cut government responsibility for social security, health and education and to force all state institutions to be self-financed. Furthermore, it has also meant that the government increasingly lacked funds for the investment programs for the reforms themselves, thus exaggerating dependency on foreign funding. Perhaps, most significantly in the long run, under-funding of the central government has undermined the ability of the state to use the very macroeconomic financial methods on which it depended to control the market and, thus, to maintain its claim to "socialist goals" (Weil, 1996, p. 75).

The VAT, introduced in 1986, was first applied to 14 selected commodities. The VAT was designed to replace the product tax as the major indirect tax on the production of goods. However, the complicated tax structure created new problems and the newly-introduced tax system itself was abandoned. It was replaced by the Contract Responsibility System, which was characterised by extensive bargaining between the centre and enterprises and was also seriously distorted and insufficient. The tax liabilities of enterprises should have eliminated distortions and not been subjected to discretion by the creation of an explicit taxation system as a substitute for the former implicit revenue system. In order to avoid these problems, new economic regulations, issued in November 1993, included a shift from government dependence on a share of profits to a more tax-based system and an increasingly even distribution of the tax revenues between the centre and the localities. In 1994, China introduced a major tax reform, initiating clear distinctions between national and local taxes and establishing a national tax bureau and local tax bureau, each responsible for their own tax collections. It was determined that value added tax would become the major indirect tax to be collected by the central government and shared with local government at a fixed ratio of 75:25 (Cao *et al.*, 1999, p. 116). However, regionalism has already become so far advanced, and the ties between local government officials and enterprises so close, that there was great resistance to changing the tax system. The decline of national authority may simply not be reversible by the belated top-down attempt to reassert control from the centre.

2.6 International trade

In 1979, trade liberalisation policies were introduced to facilitate exports and, for the first time, to allow for foreign investment. In essence, these efforts involved the break-up of the monopoly of foreign trade held by the central government, transferring this authority to local governments. Special economic zones were set up to free foreign investors and domestic exporters from red tape. Real devaluation, natural comparative advantage and the entrepreneurial energies of a receptive expatriate community also contributed to China's trade performance. Nevertheless, it is doubtful that trade would have grown in the way that it did if restrictive national regulations had not been substantially mitigated by local authorities taking advantage of the possibilities offered by extensive decentralisation.

China went to great lengths to attract foreign capital and foreign technology. Both rapid economic growth and higher incomes increasingly depended on the input of ever-larger amounts of capital from abroad, and expatriate investors were a potentially important source of linkage with the world economy. In contrast to China, transition economies had relied too much, and to some extent even passively, on foreign aid and foreign advice in carrying out economic reform. In the Chinese case, foreign advice was accepted only selectively. "China's reform programme was largely shaped despite, not because, of foreign advice" (Nolan, 1995, p. 23).

Powerful pressures from the international system and the desire to join the WTO have greatly influenced China's internal transition. The desire to join the WTO also prompted China to reduce import duties and to eliminate many import quotas in favour of tariffs. The foreign exchange reform established a managed floating system and unified the dual exchange rate system on 1 January 1994 (Lin *et al.*, 1996, p. 218; McKinnon, 1993a, p. 78; Perkins, 1994, p. 33).

However, "opening to the world" can only be accomplished by increasing conformity to capitalist norms, which raises fundamental issues for Chinese domestic society and its re-subordination to outside powers (Weil, 1996, p. 153). The Chinese themselves are caught between their desire to hold on to an historic independence, which is seen as inseparable from the protection of national sovereignty, and their need for foreign investment and trade. In the first place, whether largely foreign-funded capitalist development, intentionally introduced by the government, can be controlled, or whether the most powerful figures in the current leadership even want to control it, is a fundamental issue today. From this perspective, the only question is whether there will be conversion to a totally private form of capitalism. No doubt a complete reversion to a capitalist system is the goal of many within the burgeoning privatised sector, while some elements within the government, especially those most closely tied into foreign ventures and joint enterprises, must share these ultimate aims (Weil, 1996, p. 76). In reality, local governments competing to attract overseas capital typically bend to investors' demands. Moreover, many local cadres cultivate good relations with foreign owners in their own personal interest. Even though, they know perfectly well what the working and living conditions in foreign owned factories are, they would never intervene to do anything about them (Qinglian, 2000, p. 85). In addition, illegal outflow of private funds, amounting to $US20 billion annually, even before the Asian financial crisis of 1997-1998, has induced further illegal capital flight (Lau, 1999, p. 70). In this way, the internal "socialist" market and the external "capitalist" market have been employed to stimulate and accelerate economic growth, and have become inextricably linked, to the point that they are not distinguishable (Smith, 1993, p. 92; Weil, 1996, p. 227).

2.7 Social policy

In China, employment in an enterprise provides a full set of social benefits. A job within an enterprise almost always comes with employer-provided housing with minimal maintenance costs, free health care, maternity payments, worker's compensation and other forms of insurance, a pension, and other resources such as schools and recreational facilities. This set of social services, funded by the enterprise, has been metaphorically named the "iron-rice bowl" (Minqi, 1996, pp. 1-2; Weil, 1996, p. 33). The amount, and even the nature of social benefits, are unspecified and vary among enterprises. Consistent with the dominance of informal institutions, the social benefits are not determined by explicit agreements but, instead, are a "consensual" sharing of enterprise resources. Consequently, the productivity of China's state enterprises might be underestimated, since the social benefits produced in the enterprises are not included as an output. As well, the argument that the collective-private sector is efficient while state enterprises are inefficient might be due to the fact that state enterprises offer much higher social benefits than the collective enterprises. Thus, while the expenditure of the central government in China on welfare is minuscule, in CEEFSU the welfare provision was funded by direct budgetary expenditures (Johnson, 1994, p. 70; Sachs and Woo, 1994, p. 109).

The "iron rice bowl" is a form of socialism that organises society in its entirety, including its class relations and the degree of egalitarianism. These socialist elements have remained, up until now, surprisingly, resistant to a direct attack by the liberalisation process (Weil, 1996, p. 35). The current enterprise-based social security system imposes uneven burdens on enterprises and impedes labour mobility. The absence of a national, non-enterprise based social security system also makes it difficult for the government to allow inefficient enterprises to go bankrupt. Consequently, there is pressure to change the structure of social provision. This is due to the fact, there has been a sharp increase in the cost of funding social services because of the growth of China's population and the deterioration of the financial position of state enterprises (Smyth, 2000, p. 70). In general, though, the net result of the reform process was an improvement in the most basic indicators of welfare: death rates, life expectancy, official infant mortality and the number of people living in absolute poverty (Johnson, 1994, p. 62). However, there is disturbing evidence that unreported mortality rates for newborn females rose because of the severity of the One Child Campaign (Nolan and Sender, 1994, p. 336).

3. Conclusion: were the Chinese transition reforms a feasible alternative for CEEFSU?

China has been successful in stimulating economic growth, achieving an economic development process that has taken several decades in industrial countries. The policies chosen were the result of complex historical factors, leading to fundamentally different approaches and outcomes than those attained in CEEFSU. However, many problems continue to exist in the transition to a market economy in China. Importantly, there are areas of poverty as a result of significant regional disparities and, at the same time crime, corruption, bribery and extortion. Administrative interference, price manipulation, inefficient state-owned enterprises, and attempts to monopolise production and trade at the local level, all underscore the need for checks and balances for an effective market economy. The majority of the literature, of course, recommends the initiation of reforms aimed at establishing a full market capitalist system.

China's market-oriented reform appears to have become irreversible. At the same time, China today stands on the brink, facing fundamental choices as to the direction the country should take. Actually, the name of the system may have had little effect on its actual practices. The balancing act of the Chinese leadership between the revolutionary socialism implemented by Mao Zedong, emphasising public ownership and welfare, mass-based collectivism and egalitarianism, and the market reforms of Deng Xiaoping, with their increasingly capitalistic characteristics, privatised forms of property and class polarisation, have now reached a level of contradiction that must be resolved. Indeed, the analysis of China's reforms, in this paper, reveals that the dynamic process of change tilts towards market capitalism.

While the Chinese model has produced rapid economic growth, the system has come to look more and more like capitalism with Chinese characteristics, instead of socialism with Chinese features (Weil, 1996, p. 229). Ironically, despite its retention of socialist language and even Communist rule, building capitalism around the edges of a still-functioning state socialist system has proved to be a more viable path to capitalism than the processes adopted in CEEFSU. Consequently, since the Chinese process of transition to a market economy most likely would evolve into a market capitalist system, then the process becomes relevant as an alternative strategy for CEEFSU. The transition economies were not interested in a market socialist model of transition. However, the analysis of the Chinese reforms does not lead logically to the easy conclusion that CEEFSU should have followed the Chinese.

The transition process in China has maintained political-ideological authoritarianism and state control of the whole economy. Non-pluralism was not only a characteristic of the political and ideological structure, but was also manifested in the macro economy. *Per se* non-pluralism is the foundation of the political-ideological-economic structure, based on which the transition process is unfolding in China. Subsequently, the maintenance of non-pluralism as a strategy incorporated in the transition process renders the Chinese model undesirable for CEEFSU. To a certain extent, the whole sequencing debate was irrelevant. Most states have little choice in the road they take. "Political outcomes are far from a matter of choice by governments" (Nolan, 1995, p. 156). Gorbachev attempted to begin the Soviet reforms with economic change, only to be stifled by entrenched bureaucratic and industrial interests. Without *glasnost*, without political reform, there would have been little chance for economic change (Johnson, 1994, p. 64). Gorbachev's own visit to China during the Tiananmen demonstration must have strongly reinforced his feeling that the Chinese reforms could not be a feasible route for the Soviet Union (Nolan, 1995, p. 251). Who would like to recommend to CEEFSU trading democracy for growth? Stalinism was externally imposed on Eastern Europe, and it was very difficult to imagine a Communist Party government retaining legitimacy through the transition process. Moreover, the transformation in the Soviet Union was taking place against the backdrop of revolution in Eastern Europe in 1989. This was itself a direct consequence of *perestroika* and *glasnost*. The unleashing of *perestroika* and *glasnost* in the USSR had produced a similar impact on social consciousness in Eastern Europe. The mass demands for democracy and independence from an artificial unification of historically independent states was unleashed with the introduction of *perestroika* and *glasnost* in the Soviet Union and with it the propensity for the respective countries to split into separate political units. When Gorbachev made it clear that the Soviet Union would not intervene, as it had done in 1968, one by one the Communist-led governments in Eastern Europe started to collapse. Hence the success of the Chinese economic reforms was fundamentally based on a non-pluralistic economic-political-ideological structure, which effectively made the process inapplicable to CEEFSU. Therefore, it was not the "special initial conditions" of China that made the model inappropriate but, rather, the switch to a democratic political-ideological-economic structure in transition economies. The governments of transition economies neither had the mandate, nor wanted to reimpose tight state direction of the politics, ideology and economy.

As it becomes apparent from the aforementioned analysis, there may be no Chinese model of development which could have provided the CEEFSU countries with a well sign posted alternative fitting their circumstances in the first half of the 1990s. The Chinese were "improvising" as they went along, and what is now viewed by some as a calculated strategy of gradualism, did not offer CEEFSU countries, a recipe for transition. At the end, it appears that the strategy was only rendered workable in China because the Communist Party was able to retain tight control over the state and was not being buffeted by political forces, a precarious economic situation, and confusing advice from foreign sources into taking radical measures.

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