

## Economic Reform in China

The inefficiency of China's traditional economic system was first recognized in the 1960s. Attempts to solve this problem can be traced back to that period. However, fundamental changes did not take place until the Third Plenary Session of the 11th Chinese Communist Party Congress in December 1978. Before that, economic reforms existed only in the form of a re-delineation of economic and administrative functions among sectoral and regional governments, and in a corresponding cyclical increase or decrease in the number of administrative authorities. The basic trinity of the traditional economic system remained intact.

Unlike the reforms preceding it, the one put in place in 1978 had two distinct features. First, the reform was not done through the assignment of administrative functions to different government agents. Instead, enterprises and farmers were given more production and management autonomy. Second, as the reform proceeded, the reformed micro-management institutions often ran into conflicts with the planned resource-allocation mechanism and the distorted macro-policy environment. Despite the fact that institutional regression occurred several times, overall, there was no retreat to the traditional system. Rather, the reform became further reaching, beginning with the micro-management institution and continuing into the areas of the resource-allocation system and macro-policy environment. The reform of the resource-allocation system and the macro-policy environment, in return, helped to solve the remained problems in the reform of micro-management institutions.

This chapter examines the economic reform that started in late 1978. We will categorize the reforms into those of the micro-

management institution, the resource-allocation system and the macro-policy environment, and discuss them accordingly. We will use major reforms to analyze the evolution process of the reform and to illustrate the intrinsic logic behind this process.

### **5.1 Differences between Pre-1978 and Post-1978 Reforms**

Until 1978, there were no major changes made in the basic framework of China's traditional economic system. After 1978, however, reform gradually breaks the internal integrity of the traditional economic system.

Before 1978, the economic trinity was regarded as the formal realization of socialism. Therefore, reforms had not touched on the basic framework of the traditional economic system. Major measures of the pre-1978 reforms included (1) eliminating the central government's over-concentration of power by decentralizing administrative authority and responsibility and (2) eliminating unequal distribution of earnings among regions and sectors by adjusting their administrative authority and responsibility.

However, these changes only altered the ability of the local and sectoral authorities to allocate resources. The traditional development strategy, and accordingly the distorted macro-policy environment, the planned resource-allocation mechanism, and the puppet-like micro-management institution were left intact. Since their vested interests were lost through administrative adjustment, local and sectoral authorities would naturally try to regain the interests in the new round of adjustments. Economic reforms were thus caught in the cycle of decentralizing and re-centralizing administrative power and in the corresponding repetitious cycle of expansion and reduction in administrative organizations (see Table 5.1). For several decades, to implement the heavy-industry-oriented development strategy, China and many other countries relied on the trinity of the traditional economic system. None of them succeeded in achieving economic development. This taught China's leaders that the prevailing economic theories and practices could not solve China's problems.

Table 5.1 Pre-reform Decentralization and Re-centralization Cycle

	1953	1957	1958 (year-end)	1963	1971-73
Number of SOEs under direct control of the central government	2,800	9,300	1,200	10,000	2,000
Number of materials allocated by state commissions and ministries	227	532	132	500	217

Source: Yu Guangyuan, ed., *China's Socialist Modernization*. Beijing: Foreign Languages Press, 1984, p. 76.

To develop the economy, the traditional economic system had to be fundamentally reformed.

The economic reform that began in 1978 signified Chinese leaders' search for a new path toward the realization of socialism. The basic framework of traditional economic system was no longer off limits, this enabled reform to penetrate all levels of the economic system. Thanks to the thorough and increasingly powerful reforms, compulsory plans were gradually replaced by indicative plans, and the planned allocation mechanism was replaced by a market mechanism. The new economic system gradually took shape as a result of the survival-of-the-fittest process.

There are several reasons behind China's decision to implement a new type of reform. First, the heavy-industry-oriented development strategy had not achieved the intended goals. Rather than enabling China to surpass developed economies, this strategy enlarged the gap between China and developed countries. The income levels of urban and rural households remained stagnant. There was a serious shortage of daily necessities, and several hundred million peasants still lived under the threat of starvation. The national economy was on the verge of collapse after 10 years of turmoil during the Cultural Revolution, which lasted from 1966 to 1976. These factors

stimulated Chinese leaders' re-evaluation of the traditional economic system.

Second, during the same period, while China was pursuing the leap-forward strategy, neighbouring countries and regions, especially the four Little Dragons who were originally at the same footing with China in terms of economic conditions, developed rapidly and emerged as newly industrialized economies. The gap between China and these economies widened, exerting great pressure on China's leaders to institute reforms.

Third, the micro-management units (i.e., SOEs and the People's Communes) suffered from low economic efficiency and insufficient production incentives. When the new leadership resumed power after the Cultural Revolution, the death of Chairman Mao, and the purge of the ultra-left Gang of Four, they hoped to strengthen their legitimacy by using reform measures to speed up economic growth and improve people's living standards.

Moreover, shortfalls deriving from the leap-forward strategy became more apparent over time. As people's living standards failed to improve decade after decade, the opportunity cost of discarding the traditional economic system fell. This lowered cost also played a major role in pushing China to reform its economic system.

## **5.2 Reform of the Micro-management Institution**

As discussed in Chapter 2, the adoption of the heavy-industry-oriented development strategy resulted endogenously in the formation of the price-distorted macro-policy environment, a highly centralized planned resource-allocation mechanism, and puppet-like micro-management institutions. The distortion in the prices of production factors and products was the key component in the trinity. Their underlying connections can be described as follows: (1) a macro-policy environment with depressed interest rates, exchange rates, and prices for scarce goods was seen as the prerequisite for developing nonviable heavy industry; (2) the planned resource-allocation mechanism was implemented in response to a distorted

macro-policy environment in which total demand exceeded total supply, so as to guarantee that resources go to heavy industries; and (3) puppet-like micro-management institution was adopted to prevent SOEs from corroding profits and state assets by abusing their autonomous power. In rural areas, the People's Commune system was created to guarantee that the state monopolize the purchasing and marketing of agricultural products.

Both the distorted macro-policy environment and the highly centralized planned resource-allocation mechanism were inherently problematic but not so intuitively clear. The relation between production inefficiency and the lack of incentive for workers and peasants was, however, highly evident. This explains why the post-1978 reforms began with the micro-management institution. In rural areas, a household responsibility system was initiated. In cities, a series of comprehensive and specific reforms was carried out to address the management of SOEs, which were focused, at the time, on decentralization and profit sharing. These two aspects of the reform are elaborated upon below.

### *1. The Household Responsibility System*

From the collectivization movement in the 1950s to the introduction of the household responsibility system in the late 1970s, the production team system was the basic farming institution in China. Under the production team system, each labourer received a *gongfen* (work point) each day for their work. At the end of the year, the net income of the production team — after state taxes and allocations for public accumulation funds and public welfare funds were deducted — was allotted to each individual according to his or her *gongfen*. The nature of agricultural work makes good supervision exceedingly costly. The linkage between work points earned by a worker and the contribution done by the worker was extremely weak. Because the work point system could not accurately reflect the quantity and quality of the work done, it severely dampened labour incentives. The fact that workers were forbidden to exit the commune (an important mechanism to prevent free riding) further reduced their

incentive to work.<sup>1</sup> The outcome was that an absolute shortage of agricultural products became a persistent, unsolvable problem. In order to improve labour incentives in agricultural production, the household responsibility system was introduced in the late 1970s.

The development of the household responsibility system itself can be roughly divided into three phases: the work-quota contract phase, the output-quota contract phase, and the responsibility contract phase. Every phase experienced the same evolution process from the contract with a group of workers, to the contract with each individual worker, and finally to the contract with a household. The three major modes in this evolution process were the group work-quota contract, the household output-quota contract, and the household responsibility contract.

Under the group work-quota contract, the production team assigned a certain work quota with pre-specified requirements for time, quantity, and quality to a group of workers and then rewarded or punished the whole group according to its performance. With quantity, quality, time limit, and compensations for their work clearly defined, work teams would be formed voluntarily, labour supervision costs would fall, and free rides would be avoided. All this would create a stronger incentive to work.

Under the household output-quota contract, a specific output quota and plot of land were assigned to a household. The household was responsible for delivering to the production team a pre-determined quantity of output. Output exceeding the quota would be given to the household or shared between the household and the production team. There are two differences between the household output-quota contract and the group work-quota contract. First, under the household output-quota contract, contracts were extended from one stage of the production process to the entire process, thereby

---

1. Justin Yifu Lin, "The Household Responsibility System in China's Agricultural Reform: The Theoretical and Empirical Study", *Economic Development and Cultural Change*, Vol. 36, No. 3 (April 1988) (Supplement), pp. S199-S224; Justin Yifu Lin, "Collectivization and China's Agricultural Crisis in 1959-1961", *Journal of Political Economy*, Vol. 98, No. 6 (December 1990), pp. 1228-52.

eliminating the difficult task of assessing intermediate performance in agricultural production. Second, the unit of the contractor changed from work groups to households, thereby eliminating the difficult task of labour supervision and the problem of free riding.

Under the household responsibility system, land was assigned to each household according to the number of its members or according to the number of both its members and workers. Households were required by the contract to pay state taxes, fulfil contracted procurement quotas, and submit certain amount of produce to the production team as public accumulation funds and public welfare funds. After these obligations had been fulfilled, all remaining output belonged to the household. The most significant difference between the household output-quota contract and the household responsibility system was the cancellation of unified income allocation by the production team in the latter.

The household responsibility system evolved from being absolutely illegal, to being partially legal, to eventually being promoted by the government. During the years of the People's Communes, production teams adopted certain responsibility contracts with households whenever agriculture ran into difficulty. This was effective in the short term, but, since it did not match socialist ideology, it was abolished repeatedly.<sup>2</sup> As early as the 1950s, when the People's Commune system had just been established, the household responsibility system emerged and then faded from view. During the late 1970s, when the national economy was on the verge of collapse, the system revived. Fortunately, this time it was tolerated as an exception rather than being condemned outright as a return to capitalism.

In September 1979, the Central Committee of the Chinese Communist Party passed *The Decision on Certain Issues Concerning*

---

2. Because agriculture does not display many characteristics of a scale economy, and because supervising and measuring agricultural work is difficult, agriculture is suitable for household operations. The fact that household-based agriculture could prosper in market economies in developed economies suggests that household operation is not an institutional barrier for the modernization of agriculture.

*the Acceleration of Agriculture Development*. This document stipulated that — with the exception of the special needs of some sideline productions and isolated households in remote areas — production contract with household was not allowed. This was the first official indication that production contract with household could exist as an exception. In the late 1980, as the household responsibility system had significantly helped to address the issue of food and clothing, the government further relaxed its policies. Meeting minutes issued by the Central Committee of the Chinese Communist Party, titled “Issues Regarding Further Accelerating and Perfecting the Agricultural Production Responsibility System” in Autumn 1980, stated that “in the remote and poor areas, production should be contracted to households, in the form of household output-quota system or the household responsibility system, if the team members wanted to do so.”

Under this more lenient government policy, the proportion of production teams adopting the household output-quota contract system or the household responsibility system soared from 1.1% at the beginning of 1980 to about 20% at the end of 1980. By that time, the poorest production teams had all adopted the household output-quota contract system or the household responsibility system. The new policy greatly improved rural workers’ production incentive. Wherever the household contract system was adopted, agricultural output increased substantially. Given the success of the household contract system, the government further relaxed its policy in 1981, and in 1982 it eliminated all restrictions, which respectively enabled 30% of lower-middle income production teams and 30% of higher-middle income production teams to implement the new practice. In 1983, an ideological justification was provided for such a micro-foundation reform. The household responsibility system was explicitly accepted as an integrated operational mode combining individual management and unified operation in the socialist collective economy, which was regarded different in nature from the small private economy. As such, the system was “in line with the current stage of development, where agricultural work is pre-dominant manual, and the characteristics of agricultural production. The system is also conformed to the needs



of productivity improvement in the modernization process.” Thus, another 15% of the teams, those with high incomes, were added to the list. In 1984, the government promulgated new methods and measures by which to strengthen and improve the household responsibility system. The measures brought the remaining 4% of the best production teams into the system, which marked the completion of the reform of the system in rural areas.

Statistical data reveals that total agricultural growth and average annual growth from 1978 to 1984, when the household responsibility system became predominant, stood at 42.23% and 6.05%, respectively, after price adjustment. Such growth had not been seen since the founding of the People’s Republic of China in 1949. The household responsibility system was the main reason for the high growth rate. An econometric study shows that 46.89% of the total output increase in the period can be attributed to the household responsibility system. Although other factors, such as the increases in the procurement prices of agricultural products and the decreases in the prices of agricultural inputs, also contributed to growth, none had made as significant a contribution as the household responsibility system did.<sup>3</sup>

The reason that the household responsibility system could be the major contributor to agricultural development was because under the system, households were permitted to keep anything they produced after they had fulfilled state quotas. This makes farmers become the residual claimants and stimulated farmers’ initiative to increase their production.<sup>4</sup> Thus, China’s comparative advantage in agriculture — abundant labour — could be fully exploited.

---

3. Justin Yifu Lin, “Rural Reforms and Agricultural Growth in China”, *American Economic Review*, Vol. 82, No. 1 (March 1992), pp. 34–51.

4. The rural reform in China did not change rural land ownership. The household responsibility system can be regarded as a kind of leasing system. Under the household responsibility system, farmers can keep all residuals after fulfilling their quota obligations. Therefore, the system is quite similar to the fixed-rent leasing system. The household responsibility system can link an individual worker’s effort and his/her reward much better than the work-point system in the production team and a share tenancy system. Therefore, the household responsibility system can effectively bring the farmers’ initiative into full pay.

An important endeavour that further improved the household responsibility system was establishing and improving the dual-level operation system in agriculture. In the early stages, the collective level in the cooperative economy was largely unable to provide various services necessary to the household level. Thus, the dual-level system was nominal. Agriculture infrastructure, the supply of production factors, and the sale of agricultural products are all characterized by economies of scale. In order to benefit all farmers from these externalities and economies of scale, collective cooperation had to be promoted to serve the needs of rural households. Statistics show that in recent years the cooperative operation has gradually expanded in scope. It has helped promote farming technology and has improved crop variety and animal breeding. The construction of water conservancy works has developed much more quickly in recent years than in the early stage of the rural reform. Sales of staple agricultural products have also enjoyed a strong rising momentum. As a whole, there is still much to be done at the cooperative level, including expanding marketing services to reduce transaction costs and organizing farmers to participate in the construction of public utilities. For example, the constructions of irrigation projects through the system of compulsory labour services could be launched to allow farmers to benefit from external economies of scale.

Meanwhile, grassroots economic organizations are reformed. Under the People's Communes, grassroots organizations had been set up to serve the leap-forward strategy. Community organizations were needed to serve several functions. First, they helped control rural production resources so that such resources could not flow out of the agricultural sector and could be used in the production sectors required by the state. For example, community organizations had to ensure that rural labour forces would not be transferred out of the agricultural sector and to guarantee that the surplus and accumulation of rural production would be controlled by the state. Second, these organizations helped control the sale of agricultural products and levy agricultural taxes. Their most important function was to ensure that major agricultural and sideline products were sold at fixed prices

to state commercial institutions, where the state could levy a hidden tax from the price scissors between the agricultural and the industrial products. Third, the organizations exerted control over almost all aspects of social, political, and economic life in rural communities. Family planning (population reproduction) is such an example.

The grassroots organizations set up to fulfill these functions were the product of the government's institutional arrangement rather than the choice of the community. This mandatory institutional arrangement ruled out any "exit" options. As long as their mandate to serve the state's industrialization strategy remained unchanged, these organizations would remain mandatory, and no exit would be permitted.

Almost simultaneously, and with the same enthusiasm with which they discarded the People's Communes, rural residents began looking for another kind of cooperative organization. If the People's Communes were a comprehensive community organization covering industrial, agricultural, military, educational and business functions, the organizations that rural residents sought should cover a wide range of fields as well. Such organizations as agricultural technology associations, farmers' economic associations, specialized technique associations (technical services and sales cooperatives associations), and rural cooperative funds drew attention from the media as well as from scholars and policy researchers. At the same time, there remained a tiny proportion of communities that maintained the form of collective farming. In the 1980s, rural industry became the leading force behind rural economic development; 60% to 70% of rural output value was produced by township and village enterprises (TVEs). Cooperative organizations were voluntary. Farmers could exit when government intervention or the high cost of free riding damaged work incentives. By solving the incentive problem, the cooperatives created economies of scale that rural residents recognized as desirable.

We can divide rural community organizations into two types — the voluntarily-formed cooperatives for pursuing certain benefits and the mandatory community organizations imposed by the government to effectively reduce taxation costs. The basic difference between the two lies in the compatibility of incentives between the organization

and its members. In the former case, the farmers encounter economies of scale, or an external economy, in the community's economic activities, such as production, marketing, and credit. They may choose a mutually acceptable cooperative organization and may exit whenever necessary. This ensures that everyone can benefit. In the latter case, the state imposes an organization on rural residents, aiming to lower taxation costs. The main consideration in forming such an organization is the state's benefits rather than the farmers' benefits. Farmers cannot withdraw from these organizations. Once the right to exit is denied, free riding will occur, leading to the failure of the organization.

As discussed above, the People's Commune system came into being to serve industrialization by effecting a mandatory drain on rural surplus. Taxation was carried out through the control of basic rural production factors, the monopoly in the circulation of agricultural products, and especially the price scissors between industrial and agricultural products. Chinese economists have assessed the total value drained from agriculture through scissor pricing from the 1950s to 1980s. Because they used different definitions and data processing, their results differ. But most scholars agree that there was a net unilateral outflow of agricultural resources to other sectors. For example, in the mid-1980s a group of economists at the Development Research Institute estimated that rural workers contributed at least RMB 800 billion to industrialization by scissor pricing in the three decades. Li Wei asserted that from 1955 to 1985, the government drained a total of RMB 543 billion via the scissors gap. If we add the total amount from the three arenas — public taxes, price scissors, and the deposit net outflow — this figure reaches RMB 692.6 billion. Zhou Qiren made a similar estimate: The state gained RMB 612.7 billion through agricultural taxation, unfair exchange, and net deposit outflow from 1952 to 1982.<sup>5</sup>

China's former rural economic system had some incurable defects in respect to the incentive mechanism. The resultant production inefficiency became so serious a problem that the system could no longer provide the government with sufficient agricultural

surplus. When farmers began to discard it in the late 1970s and early 1980s, the government acquiesced. However, capital accumulation through taxation, price distortion and through the financial drainage mechanism in the banking system was not discarded completely. As long as the state continued to rely on unfair exchanges in order to divert agriculture resources for industrialization, it would maintain control over community organizations to serve the goal. Neither the grassroots government organizations (governments at town or township levels) nor the farmers' autonomous organizations (village) could possibly evade the obligation. Farmers' attitude towards economic organizations presented itself as a unique phenomenon from abandoning to re-seeking. During different stages of development in agriculture and the national economy, the functions of rural community organizations may change. When it became unnecessary to rely purely on community organizations to levy taxes against farmers, they were able to gradually transform themselves so farmers could benefit from economies of scale and the external economy. Under these circumstances, the exit right is protected. Rural organizations will help to bolster the incentive to work. Therefore, the cooperative economy is no longer destined to fail again.

## 2. *State-owned Enterprise Reform*

The reform of China's SOEs took place at about the same time as the rural reform, and the former has gone through three phases. The first phase (1979–84) focused on granting SOEs a certain amount of autonomy in exchange for higher efficiency. Unlike the previous

---

5. Please refer to: Development Research Institute, *Reform Facing Institutional Challenges*. Shanghai: Shanghai Sanlian Bookstore, 1988; Li Wei, *Rural Surplus and Industrial Capital Accumulation*. Kunming City: Yunnan People's Press, 1993; Qiren Zhou, "China's Rural Reform: The Changes in the Country and the Relationship of Ownership — A Retrospect into the Vicissitudes of Economic Institutions", in Unirule Institute, ed., *China Economics, 1994*. Shanghai: Shanghai People's Press, 1995.

approach, this time the reform was mainly done through the sharing of management power and profit between government and SOEs. It was hoped that in pursuit of their share in the newly created profit, managers and workers would put in more effort in production and make a more efficient use of resources, so that in the end, both the social welfare and individual income would increase accordingly. In October 1978, pilot reform programmes delegating more powers to SOEs were applied to six SOEs in Sichuan Province. In May 1979, the State Economic Commission, the Ministry of Finance, and four other ministries decided to apply such pilot programmes to eight SOEs in Beijing, Tianjin, and Shanghai, the three municipalities under direct control of the central government. These pilot programmes evoked strong positive responses in workers in many SOEs. A large number of regions and departments followed suit and worked out their own pilot programmes.

The major measures taken in the experiments were aimed to expand the management autonomous power at the local and micro level and enhance their concern for economic efficiency. The measures included pay raises, bonuses, and retention of profits in enterprises so as to stimulate the work incentives of workers and managers, and the decentralization of fiscal authority and resource-allocation autonomy to the local government and concerned ministries so as to make them more concerned about the economic performance of enterprises. For many years, worker's income was linked only to seniority rather than performance. All SOE expenditures were reimbursed by the state. All profits were turned over to the state. The above-mentioned changes produced remarkable results. In the autumn of 1980, given the successes of the experiment, the central government introduced the reforms to more than 6,000 industrial SOEs, which accounted for 16% of all SOEs in number, 60% of all SOEs in terms of output value, and 70% of all SOEs in terms of economic returns for the whole country.

Profit retention indeed had a positive effect on incentive. However, because of the unchanged distorted macro-policy environment under which SOEs' losses or profits did not accurately reflect their management, power delegated to SOEs also made it possible for

some managers to embezzle funds from SOEs' returns. Enhanced working incentive did not guarantee complete fulfilment of state financial quotas. To solve the problem, Shandong Province took the lead by changing the profit-retention system to a profit-quota system in the early 1980s. Under the profit-quota system, SOEs had to turn over some profits to the state, while all or part of what remained was at their own disposal or was divided between SOEs and the state. Soon the so-called "industrial economic responsibility system" was approved by the state, and it spread rapidly throughout the country. By the end of August 1981, 65% of SOEs at or above the county level in the country had adopted the industrial economic responsibility system. In the eastern provinces and municipalities, which bore much of the state revenues, as many as 80% of SOEs had adopted the system.

Although the reforms of the period had some positive effects, the success was limited because of the loopholes in the dual-track price system, the possibility of rent-seeking, and the lack of clearly defined boundary of SOEs' autonomy. Some SOEs even changed the goals set in the state plan, failed to fulfil the product and profit quota obligations, and competed with each other in giving bonuses to workers.

In phase two (1984–86) of the SOE reform, efforts focused on enhancing SOE vitality. The major measures put into place were to "simplify administrative control and decentralize authority", to reform taxation and introduce a manager-responsibility system. These reforms were to some extent a response to pressure exerted by emerging nonstate enterprises (i.e., township and village enterprises). Unlike SOEs, non-SOEs could not get cheap resources within the state plan. The only way they could survive and develop was to gain the upper hand in fierce market competition. However, the hard constraints turned out to be a blessing for non-SOEs. Because of the constraints, they achieved a higher degree of economic efficiency and could afford to buy resources at higher prices. Resources in short supply thus flowed to the non-state-owned sector. Competition for scarce resources became a strong impetus for the state to enact reforms that aimed to revitalize SOEs.

The second-round reform replaced profit remittance with corporate taxes, changed direct fiscal appropriation to indirect bank loans, and adopted the responsibility system and the shareholding system. All these measures were taken to deal with competitive pressure. Two reform measures were taken to invigorate the management of the SOEs. First, the government gradually reduced the SOE quota obligations. By 1990, the number of products under state mandatory plan had decreased to 58 (it was 120 in 1979). The proportion of these products in total industrial output value decreased from 40% to 16%. Important materials and merchandise allocated by the State Planning Commission fell in number from 256 and 65 to 19 and 20, respectively; exclusive state exports decreased in number from 900 to 27, and their proportion in the total value of export fell to around 20%.

In addition, a series of administrative regulations were promulgated to expand SOEs' decision-making power. Such power included the ability to control sales and marketing, set prices, select factors of production, use corporate funds, distribute salaries and bonuses, cooperatively manage ventures, and direct technical progress. In September 1985, the State Planning Commission made this policy more explicit in *Temporary Regulations on the Many Problems of Invigorating the Large and Medium-sized SOEs*. With the prerequisite of fulfilling the state quotas, the document stated that SOEs could diversify their products and operations based on market demand and their own advantages. These reform measures were in effect encouraging SOEs to make full use of their comparative advantages.

In order to smooth the relationship between enterprises and the government, in the mid-1980s, China began to replace the profit remittance system with the corporate tax system. This reform was carried out in two steps. Its main objectives were to delineate the boundary between the government fiscal income and the disposable revenue of an enterprise, and to establish a mechanism by which the government fiscal income was linked to tax revenue and enterprise's income was linked to its profits. As the first step, profit remittance was replaced by taxes beginning on 1 January 1983, and the



collection of taxes began on 1 June of the same year. More specifically, 55% of corporate income tax was levied on all SOEs, except for small ones that had adopted the contract responsibility system. In essence, the new system changed the original remitted profit (which was 55% of its total profit) into corporate taxes. The after-tax profit was to be divided between the state and enterprises. The state's share varied according to each enterprise's specific situation. The possibilities included: submitting an increasing amount of profit each year, submitting a fixed proportion of profit, submitting a fixed amount of profit, and paying an adjustment tax. The rule for each enterprise would remain unchanged for three years once it was determined.

The first step of the "profit to tax" reform was designed primarily to end the traditional practice of obscuring taxes with profits. To tackle the remaining problems, a second step was taken in September 1984, when a uniform tax-levying system was introduced. The new system made improvement to the income taxes and adjustment taxes which were introduced during the first step. It also introduced more taxes, such as those for fund-raising, city maintenance and construction, real estate, land use, and vehicle ownership, as well as the product tax, value-added tax, sales tax, and salt tax. The new system was effected on 1 June 1985. The second step produced satisfactory results at the beginning. However, with the economic accounting and auditing system yet to be strengthened, SOEs could increase their income and reduce the tax burden through various flexible methods, for example, by dispatching labour forces to build flats for workers while the material expenses were added to production costs. It followed that government tax revenue did not increase and the SOEs that were reluctant to use these flexible means bore an excessive tax burden. The government had to roll out the tax contract system for SOEs.

There was no need to separate profit and taxes as long as the old economic system was in place. Under the old system, the state exercised direct control over SOE activities, and price did not signal resource allocation. However, in an economic environment in which price fluctuation guides resource allocation, taxes and profit must be

separated. Separating the two is thus inherent to market-oriented reform. The major purpose of market-oriented reform is to create an environment in which competition is fair. The two-step reforms failed to put into place a tax system capable of establishing a proper relationship between the central government and local governments and between the government and SOEs. Indeed, what worked in reality was the tax-responsibility system. Nevertheless, tax system reform could not have been skipped. The first two steps were a positive beginning, and they led to a system that included 20 types of taxes. This helped to pave the way for the later implementation of the tax-sharing system.

In 1988, the government launched another pilot reform programme of SOEs. The programme was called "separating taxes from profit, paying taxes before repaying bank loans and contracting for after-tax profits." The new pilot programme included the following mandates: (1) Relieved the tax burden. The adjustment tax was cancelled, and income tax rates were reduced in all SOEs. (2) For after-tax profit, set up a profit turnover base or fees for using state property. According to Shanghai's practice, the use fees of liquid assets and fixed assets were the interest rates of corresponding loans, respectively. (3) Changed the policy of paying taxes after repaying loans to one of paying tax before repaying loans, and cancelled the stipulation that SOEs drew welfare funds and bonus funds according to loan repayment.

In 1987, the SOE reform entered its third phase. In this phase, the reform focused on the reconstruction of the SOE management mechanism. The basic measure through the reform was the implementation of management-responsibility system, including the contract system in the large- and medium-sized SOEs, leasing in small SOEs, and experiments on the shareholding system. The dominant form before 1991 was the contract system. According to primary statistics from 28 provinces, municipalities, autonomous regions, and the seven fiscal-planning-independent cities (cities which were granted the same status as provinces in the central government's fiscal plan) throughout China, by the second quarter of 1987, 33,312 SOEs, whose revenues were included in the

government's budgets, adopted the asset contract responsibility system. The number made up 90% of the total number of enterprises in that category.<sup>6</sup> Since 1992, the dominant view has been that SOEs' non-competitiveness was caused by ambiguities in property rights and that the shareholding system was the best cure for the problem. Indeed, the shareholding system has become widespread. However, in reality, the system was used mainly by large SOEs as a means of raising funds. At least so far, the shareholding system has not proven successful in transforming the SOE management mechanism. Only about 1200 large SOEs have been allowed to issue shares for trading on stock markets by 2000. However, the listed SOEs' corporate governance and efficiency have not shown much improvement.

The major remaining problem was the absence of competitive markets for products, production factors, and managerial personnel. While the first two factors raised information costs for managerial supervision, the third made it hard to reward managerial talents or punish managerial ineptitude. Without autonomy, managers lack the incentive to perform well; if SOEs are granted autonomy, the infringement of managerial rights upon propriety rights occurs. All in all, the development of competitive product, factor, and managerial personnel markets constitutes the basic condition necessary for the shareholding system to work. If these markets are not developed, the scale and effectiveness of the shareholding system will be very limited. Given the under-development of the three markets, the obscurity of property rights will be more serious and the shareholding system will only bring about more managerial discretion, to say nothing of eliminating infringement of managerial power upon property rights. The shareholding system is no better than the contract system in this regard. It will only aggravate the situation. Therefore, to the SOEs with a leap-forward strategic mission, the solution was more complicated than introducing a shareholding system.

---

6. State Commission for the Restructuring of the Economic System, ed., *China's Economic Restructuring Yearbook, 1992*. Beijing: Reform Press, 1992, p. 167.

The reform of SOEs was mainly a reform of those that manufactured non-public goods. It focused on fulfilling three functions: improving the competitiveness of asset management, increasing the liquidity of assets, and enhancing the state's supervision of asset management. In chronological order it was implemented in the following sequence: "adjusting the interest relationship between the state and SOEs", "giving SOEs more decision-making power", and "establishing an enterprise system under a market economy". Just as the reform goals gradually developed as the reform proceeded, so did the goals of the SOE reform. The reform was first designed to solve the problem of inefficiency in SOEs. However, as the reform deepened, the goal was adjusted to transforming the SOE managerial mechanisms and pushing SOEs into the market.

It can be observed that, as the reform continued, the degree of SOEs' involvement in the market and their capacity to optimize resource allocation was gradually enhanced. However, so far, SOE reform has not taken a crucial step, and management is still in a dire state. Thirty-five percent of the domestic industrial SOEs within the state budget are losing a total of RMB 48.259 billion yuan in 1994.<sup>7</sup> The figure reflects only explicit losses. A much-quoted view is that one-third of the country's SOEs incur explicit losses, one-third incur implicit losses, and only the remaining one-third are making a profit. The year 1997 even saw that in certain industries all the SOEs were losing money. All these show that the Chinese reform of SOEs is far from complete.

### 5.3 Reform of the Planned Resource-allocation System

SOEs began to reap the benefits of their own profits and to produce their own products under the reform of the micro-management institution. To use the retained profits for investment, it is necessary to find more channels through which they could purchase equipments

---

7. National Bureau of Statistics of China, *China Statistical Yearbook, 1995*. Beijing: China Statistics Press, 1995, p. 403; Xie Ping, "Analysis of China's Financial Capital Structure", *Economics Research*, No. 11 (1992), p. 34.

and inputs. To maximize returns from sales of new products, it is necessary to find more channels through which they could sell the products, outside the state's plan. All these changes exerted a strong impact on the highly centralized planned resource-allocation system. To create the necessary conditions for the SOE reform, the state carried out a series of reforms in the management of materials, foreign trade, and finance. The reform of material management has been the most thorough and successful, while financial reform has proceeded most slowly.

We first discuss the reform of the materials management system. After 1978, the materials management reform was implemented with the aim to "revitalize SOEs, promote material circulation, and foster market development". It has gone through two stages. The first phase (1979–84) of reform emphasized the relaxation of state control over resource allocation in order to realize SOEs decision-making power and disposal power over their retained profit.

The major measures implemented in this period included the following: (1) The expansion of enterprises' right to sell their products. After they fulfilled the state plan and the supply contract, with the exception of special stipulations, SOEs could sell products through their own channels. Products they could sell included those made with their own materials, newly developed, trial products, and products beyond the state plan. By 1984, steel that SOEs could sell on the market accounted for 9.6% of total output, and cement produced by large and medium-sized cement SOEs that they could sell accounted for 8.8% of total output. The proportions for mechanical and electrical products were even higher. (2) Lifting restrictions on the sales of some planned allocation materials. Since 1980, among the 77 types of mechanical and electrical products and 83 nonferrous metals, only 7 were still allocated according to state plan; restrictions on all others had been lifted. (3) Adopting flexible supply methods. These mainly included supply according to fixed locations and quantity, supply according to needs after verification, supply based on a complete set of contracts, and supply according to coupons. (4) Setting up markets for production factors. During this period, related departments established many production factor

markets in Sichuan, Shanghai, and elsewhere. Because transaction activities could be carried out regardless of administrative regions, department, and enterprise ownership, consumers could choose what they wanted. These measures greatly improved resource circulation.

(5) Using cities as props to rationally organize material circulation in different economic zones and to develop a network to reduce transaction costs.

The emphasis of the second phase of reform (1985–present) was on the reduction of the variety, quantity, and scope of planned allocation materials and the establishment of production factor markets of various forms and different scales. Four main measures have been implemented during this period. First, since 1985, except for production in some key construction programmes, planned allocations have remained at 1984 levels to meet general needs. The number of materials under the unified state distribution system decreased from 256 in 1980 to 27 in 1988. The number of materials allocated under the mandatory plans of corresponding departments in the State Council decreased from 316 to 45. The number of material under state contract have decreased to 93, and the number of materials linking production and demand have decreased to 209. The number of materials that can be bought and sold freely increased to 149. Second, in order to raise the price of production factors, beginning in 1984, the state has been raising the prices of coal, timber, pig iron, steel, cement, caustic soda, sulfuric acid, and tires by means of making proper adjustments within the state plan and gradually liberalizing prices outside the plan. Third, the state has further explored the possibility of adopting indicative plan in material circulation. Fourth, the development of the market was fostered. In 1985, given the lifting of restrictions over material prices outside the plan, the city of Shijiazhuang unified the sales price of plan and non-plan materials and gave the price difference to suppliers or buyers, thus combining price liberalization with necessary subsidies in order to expand the market. By 1988, about 90 large and medium-sized cities had followed suit. Price liberalization also expanded to 16 products, including timber, cement, and pig iron. Steel that was originally within the state plan but later turned to market pricing

accounted for 60% of the total. In 1990, the types of state-allocated production factors decreased to 19. In 1992, with the number of types unchanged, the proportion of unified distribution decreased substantially. In 1994, the number was 11. By 1997, the State Planning Commission was exercising allocation plans over only crude oil, processed oil, natural gas, less than 40% of coal, and less than 3% of cars. To promote market development, in 1998 the mandatory allocation plans for steel and cement was changed into plans to match supplies with demand.

It is also important to discuss the reform in foreign-trade regime. The reform can be divided into three phases. The first phase (late 1978–86) had five goals: (1) To expand the foreign trade power of SOEs and the regional and sectoral authorities. The government introduced a foreign-trade responsibility system and delegated supervisory and approval authority over trading companies to provinces, municipalities, and autonomous regions. (2) To reform the planned foreign-trade regime by gradually reducing the number and scope of goods in the mandatory plan, increasing the variety and widening the scope of goods in the indicative plan, and drastically reducing the variety and scale of exports and imports under direct central government control. Since 1985, the responsible departments under the central government have not drawn up or assigned any mandatory plans for the procurement and allotment of exports. (3) To adjust the foreign trade financial system. The finances of industrial and state trading companies and companies under responsible departments were linked to the central government budget. SOEs with foreign trade operation rights can be made financially independent. As for the locally-arranged foreign trade, in principle, the local government should take sole responsibility for economic performance. (4) To reform the foreign trade operations. The formerly state-monopolized foreign trade enterprises were diversified and a single-commodity based operation system was changed to a manufacture-cum-trade or technology-cum-trade operation system. At the same time, foreign trade enterprises were allowed to conduct the import-export business independently, and the agency system were introduced into the trade for several commodities. (5) To

encourage regions, SOEs, and departments to become actively involved in foreign trade. To this end, a foreign exchange retention system was carried out in 1979. Although foreign exchange was under centralized management, and the central government gave priority to some key projects, some proportion of foreign exchange retention was left to foreign-exchange-earning units. The foreign-exchange-earning units had some decision-making power over the use of the retained foreign exchange. They could also participate in the swap of foreign exchange so that foreign exchange entitlement could go to other enterprises that needed it.

The second phase (1987–90) of reform focused on promoting the foreign-trade responsibility system. After a pilot programme was carried out in 1987, this reform was formally launched in 1988. Its main points included the following: (1) Adopting a state-region contract system regarding the regions' responsibility for foreign exchange quotas through exports, foreign exchange turnover quotas, and profit quotas. The base quota should remain valid for three years, from 1988 through 1990. Regions should in turn carry through these quotas to local trading companies. Most of the foreign exchange earnings within the quota would be turned over to the state, a small part would be left to local governments and foreign trade enterprises. As for the foreign exchange exceeding the quota, local governments and foreign trade enterprises would receive most of it. (2) Making the state trading companies responsible for their performance. This policy was first implemented for light industries, handicrafts, and garment industries. The major measures taken were to leave most earned foreign exchange to state trading companies, manufacturing SOEs, and local governments. Only a small part of the foreign exchange earned was turned over to the state. (3) Further the reform of the foreign-trade planning regime. Except for the 21 types of export goods of unified and joint management that remained under the dual-track export plans, all export goods were switched to a single-export plan, with local governments directly responsible to the state. (4) Further the reform of the foreign-trade financial regime. State trading companies should contract the profit quota with the state. Export tax concessions should be implemented according



to international practice. Branches of specialized local trading companies would be financially linked to local government budgets and de-linked from the central budget. (5) Further the reform of the foreign-trade operational system so as to delineate the division of management and trade activities. Only a few staple-type resource products were handled by specific foreign trade enterprises. A few other products, which were more sensitive in the international market, were handled in a decentralized manner by enterprises with the right to export. All the other products were open for competition. (6) Increasing local governments' proportion of foreign exchange retention, cancelling the foreign exchange quota, opening the foreign exchange swap markets, and allowing trading and manufacturing companies to dispose freely of their retained foreign exchange.

During the third phase (1991–present) of the reform, a management and operation mechanism of uniform policy, fair competition, and autonomous management was established, manufacturing and trade were integrated, an agency system was introduced, and a united position on trade issues was established. The government took concrete measures to end foreign trade enterprises' long-time reliance on subsidies and to push them into international markets. First, export subsidies were severed, while the proportion of foreign exchange retention was increased, so as to harden their budget constraints. Second, the practice of giving different regions different foreign exchange retention ratios was changed to the practice of establishing a uniform retention ratio nationwide for each category of commodities. The change gave the enterprises exporting the same category of commodities an equal basis for competition. Third, the central government contracted with each province, autonomous region, fiscal-plan-independent city, and specialized foreign trade company as well as other foreign trade enterprise. The contracts specified export quotas, foreign exchange earning quotas, and foreign exchange turnovers (including foreign exchange purchases) to the central government. The quotas were to be examined and approved annually. Fourth, the coordination and management function of specialized companies and the import-export associations were strengthened. Fifth, the responsibility system in foreign trade

companies was further refined. Sixth, the foreign exchange swap market was further liberalized. No ministry or bureau was allowed to use administrative measures to interfere with the circulation of foreign exchange.

The foreign-trade regime reform was originally intended to encourage export and earn foreign exchange for the import of advanced technological equipment. All the above-mentioned measures, including the reduction on the scope of mandatory plans on foreign trade, the expansion of local government's autonomy in foreign trade, and the introduction of the foreign exchange retention system, were intended to serve this purpose. In the process, the reform also greatly boosted the development and expansion of foreign trade sectors. China's total imports and exports increased in value from US\$20.64 billion in 1978 to US\$474.3 billion in 2000, with a growth rate about 5 percentage points higher than that of the GNP. Calculated in terms of RMB, the total value of imports and exports accounted for 44.5% of the GNP in 2000, more than twice that of India, Brazil, the United States, and Japan. This made China the most open economy of all the large countries in the world.

We also need to explore the financial reform in China. Capital, labour, and natural resources are indispensable for effective production. For a developing country like China, capital is the scarcest of the three factors, and has constantly been the bottleneck for economic development. Its allocation efficiency thus has the most significant impact on economic growth. Two decades of consecutive economic growth has led to the continuous deepening of financial reform, and the increase in the importance of financial sectors. Statistics shows that in 2000, the household savings deposits reached RMB 6,433.2 billion, 304.2 times more than the 1978 amount. The total amount of credit loans reached RMB 9,937.1 billion, 52.4 times more than the 1978 amount. Economic growth's dependence on finance<sup>8</sup> was 52.1% in 1979, and about 100% in 2000. It is clear that financial organizations have changed from being government

---

8. The dependence rate of economic growth on finance equals to the GNP divided by the surplus of credit loans of the banks,

accounting units to a key sector that dominates economic operations. The reform of the banking system proceeds in the following respects:

(1) The single banking system was reformed, and a more diversified financial system was roughly established, in which specialized banks was the mainstay under the direction of the central bank and other financial institutions were allowed. Before the Third Session of the 11th Central Committee of the Communist Party of China, China's banking system had been unified and consolidated. The People's Bank of China was the only bank.<sup>9</sup> It issued currency and conducted business via commercial loans and insurance. The first step of the banking reform was thus to establish a banking system. In 1979, the government re-opened the Agricultural Bank of China. The Bank of China was also set up as a specialized bank to conduct foreign exchange business and foreign exchange loans. In 1984, the Industrial and Commercial Bank of China and the China People's Insurance Company were set up separately. The former was put in charge of deposits, loans, and account settlement of industrial and commercial enterprises, and the saving services in cities and towns. The latter was independent in its operation and had its own operation system. In November 1985, the People's Construction Bank of China was made independent of the Ministry of Finance. All

---

9. Nominally, there were the People's Construction Bank of China, the Bank of China, and the Agricultural Bank of China. The People's Construction Bank of China was set up in 1954. Under the administration of the Ministry of Finance, its major order of business was to conduct relevant infrastructure construction funds allocation and settlement. In 1970, it was put under the administration of the People's Bank of China. In 1972, it broke away from the People's Bank of China and was again put under the administration of the Ministry of Finance. The Bank of China was domestically known as the administrative bureau of foreign business of the People's Bank of China. The Agricultural Bank of China was domestically known only as the rural financial administrative bureau. It later merged with the People's Bank of China twice and conducted business independently for only four years. From 1969 to 1978, the name of the Head Office of the People's Bank of China was reserved; however, all its staff and business were merged into the Ministry of Finance, and its branches were merged into corresponding financial bureaus at different levels of government.

its capital was merged into the comprehensive credit plan of the People's Bank of China and its operations also came under the leadership and supervision of the People's Bank of China. After legal tender issuance, industrial and commercial credit services, and savings services were clearly separated, the People's Bank of China became the central bank.

From 1986 onwards, the market mechanism was introduced into the financial system on an experimental basis. A horizontal capital-flow network using key cities as props evolved into interbank loan markets. Market mechanism was used to ease capital shortages. After several years, a banking system under the leadership of the People's Bank emerged, complementing the specialized banks and comprehensive banks with insurance and trust funds. Securities organizations and rural and urban cooperatives were also gradually instated.

(2) The credit management system was reformed. Under the old system, all deposits were submitted to the state, all loans were approved by the state, and all profits were remitted to the state. The income of bank employees was not related to deposits, loans, or profit the bank handled or made. Neither was there any competition pressure among different banks or different branches within the same bank. In the reform, this system was replaced by one in which credit planning was unified by the state, funds were independent between banks, issuance of loans in a bank depended on the bank's deposits, and inter-bank loans were permitted. For the management of credit funds, the former policy was changed to one in which the government only controlled the difference between planned credit, and the bank's actual credit depended on its actual deposit. The system thus allowed vertical supervision and horizontal competition to exist. On this basis, banks were allowed to take part in different lines of business. The strict business division between specialized banks was abolished. The Industrial and Commercial Bank of China could extend its business to rural areas, the Agricultural Bank could extend its business to urban areas, the Bank of China could do domestic business, and the Construction Bank could be involved in non-construction business. Banks no longer specialized in and

monopolized certain businesses. The reform led to a new two-way selection mechanism in which banks chose enterprises and enterprises chose banks.<sup>10</sup>

(3) The interest rate management system was reformed. The reform adjusted the interest level of deposits and loans, the categories of interest rates, and the management authority on the interest rate. The policy of differential interest rates, floating interest rates, prime rates and penalty rates was introduced to enterprise loans. These measures transformed the interest rate into a powerful device that could more effectively adjust the capital supply and demand, and direct the rational flow of capital. Moreover, these measures helped to foster a kind of financial mechanism that could attract more savings and convert them more effectively to investment. In April 1993, China gave up its particular way of calculating the interest of time deposits and adopted the standard practice in the world. This suggests that through its financial reform, China was attempting to approach standard world practices.<sup>11</sup>

(4) The credit system was reformed. The government partially liberalized its controls over state, commercial, and consumer credits, gave up the policy that all credit be centralized in the banks. This reform provided opportunities for the development of nonbank

---

10. The banks' business specializations were as follows: The Industrial and Commercial Bank mainly did business within industrial and commercial circles, and the Agricultural Bank usually conducted business in rural areas. The Bank of China mainly conducted foreign business, and the Construction Bank dealt with infrastructure construction.

11. China used to calculate the interest rate of the term deposit in the following way: When a depositor wanted to withdraw money, if the date exceeded the deposit certificate date, the days exceeded should be calculated according to the due term deposit rate. If the depositor wanted to withdraw the money before the maturing date, interest should be calculated according to the rate of the nearest term deposit. For example, let us suppose that a depositor has opened a two-year term deposit account. If he withdrew the money two and a half years later, the interest of the exceeded six months should be calculated according to the two-year term rate. If he wanted to withdraw it one and a half years later, if the nearest term deposit rate was a one-year rate, then the interest should be calculated according to the one-year interest rate.

financial institutions and for the adoption of various financial instruments. For example, the credit system reform led to the significant development of trust and investment companies, insurance companies, leasing companies, securities companies, securities exchanges, and nonbanking institutions such as rural and urban credit cooperatives. The reform also leads to the increasing roles of government and corporate bonds and stocks in the economy. Some traditional business, such as term bills, promissory notes, and bills of exchanges also gradually developed.

(5) Financial markets were fostered. The increase of financial institutions and the adoption of various financial instruments accelerated the development of financial markets. To date, the interbank lending market, the deposit certificate market, government bonds, the security bond market, the corporate bond market, and the stock market play an increasingly important role in the country's financial system.<sup>12</sup>

Here, we look more closely at the development of the securities market. After the founding of the People's Republic of China, the government issued the People's Victory Index Bonds and National Economic Construction Bonds a few times to stabilize prices and expedite economic construction. These bonds were non-circulating and were paid off by early 1968. After the Third Plenary Session of the 11th Central Committee of the Communist Party of China, the state launched a series of large-scale construction, which resulted in a budget deficit. The deficit in 1979 and 1980 was RMB 13.5 billion

---

12. Since 1987, in addition to treasury bonds, the Ministry of Finance also issued a series of other bonds, such as the State Key Project Construction Bond, State Construction Bond, the Infrastructure Construction Bond, the Inflation-indexed Public Bond, and special national bonds. As the scale of the bonds expanded, in 1985, the four state banks were also allowed to issue bonds, and other banks, such as the Bank of Communications and, some trust and investment companies were given the same right later. In addition, some SOEs were allowed to issue corporate bonds and stocks. These developments and the expansion of business demanded that the financial market be established quickly. At the same time, they also indirectly created conditions for its development.

and RMB 6.9 billion, respectively. To overcome financial difficulties and raise funds for construction, in 1981 the Ministry of Finance reissued treasury bonds to make up for its deficit after its borrowing and overdrafting from the central bank. From 1994 onwards, the state has not been allowed to borrow or overdraft from the central bank, and it has to make up the deficit by bond issuance. The scale of treasury bonds issuance has thus been loomingly large. By late 1997, the total amount of domestic government bonds reached RMB 910 billion. Corporate bonds reached RMB 260 billion. The proportion of treasury bonds in financial expenditures for the same fiscal year increased from 4.3% in 1981 to 26.7% in 1997 (see Table 5.2).

Table 5.2. The Scale of Government Bonds and Its Proportion in Government Expenditures

Year	Expenditures		
	Public debt volume (RMB 100 million)	Fiscal expenditures (RMB 100 million)	Proportion in fiscal expenditures (%)
1981	48.7	1138.41	4.3
1982	43.8	1229.98	3.6
1983	41.6	1409.52	3.0
1984	42.5	1701.02	2.5
1985	60.6	2004.25	3.0
1986	62.5	2204.91	2.8
1987	63.1	2262.18	2.8
1988	63.1	2491.21	2.5
1989	132.2	2823.78	4.7
1990	138.9	3083.59	4.5
1991	197.2	3386.62	5.8
1992	281.3	3742.20	7.5
1993	460.8	4642.30	9.9
1994	381.3	5792.62	6.6
1995	1028.6	6823.72	15.1
1996	1847.8	7937.55	23.3
1997	2467.8	9233.56	26.7

Source: National Bureau of Statistics of China, *20 Years of Magnificent Achievement*. Beijing: China Statistics Press, 1998, pp. 320, 367.

In addition, it is also important to look more closely at the development of the stock market. Small collective enterprises were the origins of the shareholding system. In order to ease capital shortages, they adopted methods of voluntary share purchasing by managers and workers or selling shares in public and transforming themselves into shareholding enterprises. In August 1980, the Fushun City Bank in Liaoning Province, a subsidiary of the People's Bank of China, issued RMB 2.11 million stocks for an enterprise. This was regarded as the banking system's first involvement in stock transactions. In September 1984, Tianqiao Department Store Joint Stock Company Ltd. was set up in Beijing, marking the first instance in which an SOE had turned into a shareholding company. Afterwards, pilot programmes of the stock system were carried out in Shanghai, Guangzhou, and Shenyang.

As stock companies developed and the number of stocks increased, it became necessary to establish secondary markets for stock transfer. The circulation of stocks was put on the agenda. In January 1986, in cities where pilot programmes had been carried out, such as Shengyang, Wuhan, Guangzhou, Chongqing, and Changzhou, the government allowed the financial institutions to conduct business on stock issuance and transfer. In August 1986, the Shenyang Trust and Investment Company started to handle over-the-counter transactions. In September of that year, the Shanghai Industrial and Commercial Bank in the Jing'an District set up security transaction counters — the Jing'an Securities Operation Department, the first of its kind in the country. It also created the Shanghai stock exchange market, where Feile stock and Yanzhong stock were listed.

In 1988, stocks of the Shenzhen Development Bank were formally listed in the Shenzhen Security Company, which marked the beginning of the Shenzhen stock exchange. Although the Shenzhen stock exchange started late, the transaction volume increased enormously. In 1990, the annual transaction volume reached RMB 1,765 million, 30 times more than Shanghai's 49.63 million. China's stock exchange market embarked on a rule-based stage, marked by the establishment of the Shanghai Stock Exchange



Table 5.3 Development of the Stock Market in Mainland China since the 1990s

Year	Number of listed company	Annual transaction volume (RMB 100 million)	Market value (RMB 100 million)
1991	14	43	109
1992	53	681	1048
1993	183	3667	3541
1994	291	8127	3691
1995	323	4396	3474
1996	530	21331	9842
1997	745	30720	17529

Source: National Bureau of Statistics of China, *20 Years of Magnificent Achievement*. Beijing: China Statistics Press, 1998, p. 330.

on 26 November 1990, and the Shenzhen Stock Exchange on 3 July 1991. By late April 1998, 784 companies were listed. The total market value of domestic stocks was more than RMB 2,000 billion yuan (see Table 5.3). At the same time, investment fund markets were beginning to take hold.

China's financial reform centred on three tasks: (1) to establish and improve a financial system under the leadership of the central bank in which banking finance and non-banking finance could co-exist, with specialized banks as the mainstay; (2) to promote the transformation of specialized banks into commercial banks and to develop financial markets; and (3) to establish and improve the macro-financial regulatory framework. At present, the first task of reforms is almost complete. However, much work remains to be done regarding the second and the third tasks. The major problem is that the return of financial assets are still not linked to their risks. For example, national bonds issued by the government as primary bonds usually bear little risk. Usually, their rate would be lower than the bank interest rate. However, unlike rates in other market economies, their rates in China have always been 1% to 2% higher than the deposit rate. In fact, some high-risk financial assets have not enjoyed a higher rate than have national bonds. The reason for this is that under the present system, the risks of various financial assets are still

not quite transparent. The interest rate thus becomes the financial institutions' sole means in attracting financial resources. In 1993, the government proposed a banking system reform that attempted to separate commercial banks from policy banks, establish a vertical management mechanism under the People's Bank and put an end to local government interventions. This reform is still in progress.

If we examine the budgetary appropriation and finance jointly, we find that as financial reform grew further reaching, the role of finance in investment became increasingly important, whereas the role of budgetary appropriation shrunk. Statistics show that, from 1981 to 1997, the amount of budgetary investment on fixed asset increased from RMB 26.98 billion to RMB 69.67 billion, or an increase of 158.3%. The fixed asset investment financed by bank loans increased from RMB 8.34 billion to RMB 1,546.87 billion,<sup>13</sup> or an increase of 184.5 times.<sup>14</sup> As for the total investments in fixed assets by both the public finance and bank loans, the former decreased from 76.4% in 1981 to 4.3% in 1997, while the latter increased from 23.6% to 95.7%. This change clearly shows that the enterprises' dependence on the budgetary appropriation for fixed asset investment decreased, while their dependence on banks increased. This trend reflects the market economy-oriented feature of China's reform. Because banks are more concerned with efficiency than the government, this change will induce enterprises to exploit the comparative advantage of the economy in their investment decisions.

---

13. According to the balance sheet of monetary institutions in: National Bureau of Statistics of China, *China Statistics Yearbook, 1998*, long-term and mid-term loans had substituted loans in the form of fixed assets.

14. National Bureau of Statistics of China, *The Statistical Data of Fixed Asset Investment in China, 1950-1985*. Beijing: China Statistics Press, 1987, p. 8; National Bureau of Statistics of China, *China Statistical Yearbook, 1987*. Beijing: China Statistics Press, 1987, p. 639; National Bureau of Statistics of China, *China Statistical Yearbook, 1998*. Beijing: China Statistics Press, 1998, pp. 187, 668.

## 5.4 The Reform of the Macro-policy Environment

Reforming the micro-management institution and the resource-allocation mechanism while maintaining the traditional macro-policy environment improved the external environment for profit-seeking enterprises. However, it also caused complications, such as unfair competition and rent-seeking due to the dual-track price system. To solve these problems, the reform expanded to the macro-policy environment. In a broad sense, the reform is a price reform, covering the prices of inputs (i.e., raw materials, materials, intermediate inputs, fuels) and outputs (i.e., finished products and services), interest rates (i.e., the prices of capital), exchange rates (i.e., the price of foreign exchange) and wages (i.e., the price of labour). Among these, input and output price reform, interest rate reform, and exchange rate reform are the most important.

### *Price Policy Reform*

China's price reform initially adopted a dual-track price system. Some scholars posited that a dual-track system could not succeed, since market forces could not break the bounds set by the powerful planned economy at the time. However, over the past 22 years, the role of market prices in resource allocation has been enhanced, while the role of planned prices has diminished.

The price reform targeted at consumer goods, intermediate inputs, and production factors. So far, it has gone through two stages. During the first stage, from 1978 to 1984, while relative price was adjusted, the reform did not involve the creation of a market pricing mechanism. In other words, the government raised the price of goods in shortage and reduce the price of goods in surplus, thus narrowed the differences between planned prices and market equilibrium prices.

From 1985 onward, the price reform entered its second period with the introduction of market mechanism into price formation. One major measure implemented during this period was the dual-track price system, under which prices of goods or products within the

state plan were set by the government, while prices of goods or products outside the state plan were determined by the market. The dual-track price system was achieved gradually. With the rapid expansion of production and circulation outside the planned system and the increasing importance of the non-state economy, the weight of the market-price track increased while that of the planned-price track decreased. By 1996, 93% of all retail goods, 79% of all agricultural products, and 81% of the total sales volume of production factors were priced solely by the market (see Table 5.4).

Table 5.4 Changes in Price Controls (%)

Price forms		1990	1992	1994	1996
Total volume of retailing merchandise	Government fixed price	29.8	5.9	7.2	6.3
	Government guidance price	17.2	1.1	2.4	1.2
	Market regulatory price	53.0	93.0	90.4	92.5
Total purchase volume of agricultural products	Government fixed price	25.0	12.5	16.6	16.9
	Government guidance price	23.4	5.7	4.1	4.1
	Market regulatory price	51.6	81.8	79.3	79.0
Total sales volume of the means of production	Government fixed price	44.6	18.7	14.7	14.0
	Government guidance price	19.0	7.5	5.3	4.9
	Market regulatory price	36.4	73.8	80.0	81.1

Source: State Planning Commission, Price Administration Bureau; "The Weights and Changes of Three Patterns of Prices", *Price in China*, No. 12 (1997).

In industry, the proportion of goods determined by mandatory prices decreased in total output value from 70% in 1979 to 5% in 2000. Market pricing is now the key force exerting pressure on enterprises to change their operational mechanisms.

### *Exchange Rate Policy Reform*

Under the old policy, the foreign exchange revenues and expenditures of trade and non-trade were settled according to a single official rate. Under the leap-forward strategy, the exchange rate

was distorted, which suppressed China's foreign exchange earning capacity. To increase foreign exchange revenue, the government carried out a series of reforms on the exchange rate. In August 1979, the State Council issued a regulation that provided guidelines on how to develop foreign trade and increase foreign exchange revenue. The regulation was significant because it allowed the foreign-trade sector to enjoy the "internal settlement exchange rate" after 1981. Although the department responsible explained the internal settlement rate as a price that balanced internally the imports and exports, it is actually a kind of exchange rate. Thus, two exchange rates came into being. Of the two, the externally announced official rate was linked with price fluctuations of consumer goods at home and abroad. It is used in settlements of remittances from overseas Chinese and in converting currencies for non-trade activities, like those from tourism, foreign embassies in China, foreign organizations in China, Chinese institutions abroad, and Chinese officials sent abroad. The internal settlement exchange rate was linked with the average cost of earning foreign exchange inside China plus an appropriate markup for profit.<sup>15</sup> It was used in the settlement of trade balance. The internal rate was kept constant, while the official rate was adjusted several times, which narrowed the gap between the two. In 1985 the internal settlement exchange rate was abolished. Meanwhile, changes in the national average cost of earning foreign exchange became the basis for adjusting the official rate. All the adjustments to the exchange rate after 1985 were closely linked to the average cost to earn foreign exchange in China.

Prior to the adoption of the internal settlement rate in 1979, in order to stimulate trading companies' initiative to earn foreign exchange, a foreign exchange retention system was adopted. The result was that some trading companies retained more foreign exchange than they could use, while others retained less than they wanted. As a sub-system of the retention system, a swap system was introduced to adjust the unbalanced foreign exchange surplus among

---

15. The internal settlement exchange rate in 1981 was 1:2.8 (which equals the average cost of RMB 2.53 for one U.S. dollar in 1978 plus a 10% profit).

different trading companies. In October 1980, the Bank of China provided the swap business in its branches in 12 cities, including Beijing, Shanghai, Tianjin, Guangzhou, Qingdao, and Dalian and so on. However, the scope and exchange rate were strictly restricted, which made it in effect a non-market transaction. In 1988, to promote a comprehensive foreign-trade-contract-responsibility system, the State Council decided to set up the foreign exchange swap market, and it enacted several decisions pertaining to the foreign-exchange-retention regulation. The State Council clearly stipulated the adoption of a managed floating rate in the swap market, and the exchange rate should be determined by demand and supply. It also delineated regulations on the sources and uses of foreign exchange that could engage in the swap market, the procedures for application, registration, transaction, and transfer of foreign exchange, and the responsibilities of the authorities in charge of the foreign exchange swap markets.

The exchange rate on the swap market could more accurately reflect the real price of RMB relative to foreign currencies. As the economic reform grew further reaching, it played an increasingly important role in international trade. On 1 January 1994, as an effort to expedite the development of the market system and to create favourable conditions for the early resumption of the General Agreement on Trade and Tariffs (GATT) membership, the government introduced a single managed floating exchange rate that reflected changes in market demand and supply, and interbank foreign exchange transactions were allowed. This, in essence, merged the dual-track exchange rate into one single-market exchange rate. It was a prelude to the introduction of convertible RMB, which will have a profound and persistent effect on China's adoption of the comparative-advantage-following strategy and on the overall development of a market economic system.

To countries pursuing a leap-forward strategy, it is no easy task to transform the seriously distorted planned exchange rates into market rates. There are two reasons that China's reform proceeded smoothly in this respect. First, the market-adjusted exchange rate played an increasingly important role. By 1993, 80% of foreign trade was settled according to the market-adjusted exchange rate. Second,

the market swap rate served as a reference point for adjusting the state-planned exchange rate and the degree of distortion was reduced. Thus the distortion in foreign exchange rates had a gradually decreasing impact on the economy. When the two tracks were merged into a single market track, the impact of the change was very slight.

The exchange rate reform underwent three stages. In the first stage, the state-planned single exchange rate system was made into a multiple exchange rate system (which encompassed the official rate, the internal settlement rate, and the swap rate). But the major operating rates were the first two that belonged to the planned system and aimed at stimulating exports and, to a reasonable extent, restricting imports. In the second stage, the multiple exchange rate system was reformed into a dual exchange rate system. The official exchange rate and the swap exchange rate belonged, respectively, to the planning system and the market system. The aim at this stage was to gradually make enterprises compete on the international market. In the third stage, the dual exchange rates were merged into a single market exchange rate in order to establish the market economic system.

The exchange rate reform was successful on a number of fronts. For example, foreign exchange certificates started disappearing from circulation on 1 January 1995. In July 1996, the state loosened its control over residents' private use of foreign exchange. Free conversion of RMB under current accounts was realized in December 1996, three years ahead of the government's deadline. In September 1996, the People's Bank became a full member of the International Settlement Bank, and it permitted foreign banks to conduct trial RMB business in the Pudong district of Shanghai.

### *Interest Rate Policy Reform*

Lowering the price of capital, i.e., interest rates, was a basic measure adopted to pursue the leap-forward strategy under severe capital shortages. However, this measure resulted in various problems such as the severe shortage of capital and inefficient capital allocation. These problems severely impeded the steady economic growth and

led to a widening of the gap between China and the rest of the world. To solve such problems, the government must allow the interest rate to reflect the supply and demand conditions for capital. Only then will it be able to guide the efficient use of capital and promote capital-saving technology innovations. This is actually the goal of the interest rate reform.

The measure adopted in China's interest rate reform was the adjustment of interest rates. In 1979, the first adjustment restored interest rates to pre-Cultural Revolution levels. From 1980 to 1989, financial institutions took steps to correct distorted rates by raising the deposit and credit rate on nine occasions. In September 1988, interest rates for time deposits longer than three years were temporarily pegged to the inflation rate. This was called the "value-guaranteed savings deposit". The years 1990 to 1992 saw setbacks. During this period, financial institutions lowered the interest rate of deposit and credit loans three times. The interest rate reform was in stagnation or even in regression. Owing to the under-development of non-state financial market, the lowering of interest rate did not have a significant impact on savings deposits. After 1992, non-state financial markets, such as corporate bonds and stocks markets, began to develop rapidly. Their high returns made them attractive. This triggered a deposit shift that had a considerable impact on state banks and forced the government to launch another round of the interest rate reform. The government raised interest rates in May and July 1993 and restored the value-guaranteed savings deposit which, as expected, stopped the shift of deposit from the state banks. After the mid-1990s, in order to stimulate the macro economy, the government again lowered the interest rate several times. It is clear that the government has continued its regulation of interest rate and has taken it as an important macroeconomic lever.

China's interest rate reform lagged far behind the reforms in material prices and foreign exchange rate.<sup>16</sup> This is extremely

---

16. The price reform of production factors in China adopted the "adjust first and liberalize control later" method. This meant that the price was first adjusted toward market equilibrium price and then followed by the



inconsistent with the important role that the interest rate plays in the economy. It is no exaggeration to say that if the problem of interest rate is not properly handled, investment-driven economic overheating and inflation will continue, non-state financial instruments will not develop normally, the public will not have stable expectations of the value of their financial assets, and as a result, the economy will fail to enjoy a stable growth. The difficulty of reforming interest rate policy lies mainly in the constraints of the leap-forward strategy and the overlapping of state banks' commercial and policy functions, which makes the commercialization of state banks impossible. We shall discuss this issue further in Chapters 7 and 8.

### **5.5. The Economic Logic of "Crossing the River by Groping the Stones" — China's Approach to Reform**

When China began its reform, the government did not have a well worked out reform blueprint. The adopted reform measures were intended to solve conspicuous economic problems the government encountered at that moment. The intensity of the reform depended on the government's judgment of the utmost socially acceptable intensity. These features were best characterized as "crossing the river by groping underwater stones in the way". In other words, reform proceeded step by step, moving forward at the rate the government deemed appropriate at any given time. Our analysis shows that although there have been ups and downs in the reform process, the main thrust of the reform has remained clear, and overall it is following the predictions of economic theory.

The starting point of reform was the micro-management institution reform that gave autonomy to micro-management units

---

liberalization of prices, which meant that market demand and supply would determine prices. After 15 years of reform, the pricing systems of both resources and foreign exchange changed from adjustment systems to a market system. However, interest rate still lingered in the adjustment stage.

and allowed them to share profits. As intended, the reform improved production incentives and created a stream of additional resources. With the help of the reform in the resource-allocation systems, part of the new stream of resources was allocated to sectors, which had been suppressed under the traditional economic system. Thus the preliminary goals of accelerating economic growth and adjusting the industrial structure were achieved. Moreover, the reform was a Pareto-improvement. The whole society benefited from decentralization and profit sharing. As the reform proceeded, conflicts between the traditional macro-policy environment and the reformed micro-management institution, and those between the traditional macro-policy environment and the reformed resource-allocation mechanism arose. The conflicts resulted in an internal inconsistency within the economic system. The government often chose the traditional method of administrative re-centralization to forcefully bring the reformed micro-management institution and reformed resource allocation mechanism in line with the traditional macro-policy environment. However, such an approach did not have the support of managers, workers, and peasants, who had enjoyed the fruits of decentralization reform. It also put the government in financial straits. Consequently, the government had no other choice but to extend the reform to the macro-policy environment so as to make it adapt to the reformed micro-management institution and resource-allocation mechanism.

This is how China's incremental reform has proceeded. The reform is irreversible because it started with a change in the micro-management institution. Power and benefits given to enterprises, workers, and farmers cannot be taken away again. Therefore, when the inconsistency within the trinity of economic system began to cause serious economic problems, the reform was eventually carried out in such a way that the resource allocation mechanism and the macro-policy environment were made to adapt to the liberalized micro-management institutions in spite of government reluctance. Reform has proceeded in a logically consistent manner, despite ups and downs. This is because the root of every economic problem that the reform attempted to solve possessed an economic logic of its

own. After thoroughly analyzing and summarizing China's reform process, we were surprised to discover a splendid blueprint underneath China's incremental transition to a market economy. The reform and development of TVEs is the best illustration of the gradual approach to reform. In the 1980s, three conditions led TVEs to expand significantly. First, they enjoyed cheap production factors, which facilitated the primitive accumulation. For example, their startup capital came from the collective's accumulation, banks, and credit cooperatives. Because China was so populous and migration to cities was restricted, a huge labour surplus existed in rural areas. Cheap labour forces became a major advantage for TVE development. Rural collectives had jurisdiction over land use. This was the case before and after the household responsibility system was implemented. TVEs did not have to pay for land use and had an almost unlimited land supply.

Second, as soon as they took off, TVEs began to enjoy relatively abundant market opportunities. Since the First Five-year Plan, SOEs had been developed primarily to serve the goal of heavy-industry-oriented development strategy. Before 1978, almost half of the investment in fixed assets had been spent on heavy industries and less than six 6% on light industries. This caused a severe shortage of light industrial products. Relying on their advantages in abundant labour, TVEs invested in the under-developed sectors to meet the market shortages, made quick profits, and accumulated capital. The TVEs' take-off stage happened to coincide with the period that people's incomes were rapidly increasing while their demands had not upgraded to higher quality products, TVEs' cheap products catered to market needs. TVEs, still fragile in the 1980s, benefited from the fact that the reform of SOEs came only later.

Last, but nevertheless the most importantly, TVEs faced fierce market competition from the very beginning. TVEs were not products of a planned economy. Their major supply of energy and raw materials came from outside the state allocation plan, and their products were sold outside planned channels. In the early 1980s, the reform in micro-management institution gave partial autonomy and a portion of profits to SOEs. At the same time, the dual-track system of

resource allocation and price mechanism emerged, with the market track began to grow. This allowed TVEs to enter markets and develop. On the other hand, there was also more market pressure on TVEs than there was on SOEs. More seriously restricted by their own budgets, TVEs have an inherent ability to adapt to market competition.

Any institutional arrangement has to be formed under a specific institutional structure. The change of institutional structure in general has to go through the process from quantitative changes to qualitative ones. At the initial stage of TVE development, there were political and ideological restrictions regarding private ownership. Most TVEs thus adopted a mode of collective ownership. Not until the 1990s did TVEs, facing new challenges, begin to reform their ownership structure, mainly through developing a joint-stock cooperative system. This reform, which came about spontaneously, addressed a series of problems faced by TVEs, like the ownership ambiguity, confusion about business and government function, asset stripping, and the closed nature of the enterprise. The joint-stock cooperative system started in the Zhoucun District of Shandong Province and the Baoan District of Guangdong Province and then rapidly spread throughout the nation during the 1990s.

The reform of the joint-stock cooperative system in TVEs primarily addressed the problem of how the local government can stimulate and supervise managerial personnel in collectively-owned enterprises. Early on, this problem was easy to solve via community ownership, since the number of TVEs in each community was limited, and there was no serious information asymmetry between township leaders and managerial personnel. That is, community leaders could know as much as TVE managers to guarantee supervision effectiveness. In addition, since job options were limited, salary levels and community status were enough to stimulate TVE managers to work hard. In fact, ambiguous ownership and the overlapping of business and government functions was an effective institutional arrangement at the time.

With the development of the rural economy and various forms of ownership, institutional arrangements began to change. Most

importantly, the original supervision and incentive mechanism became ineffective. TVE managers were not government officials. Their job mobility was limited and they had not much chance to be promoted. Long-term management over the same TVEs enabled them to accumulate private information. At the same time, non-collective enterprises mushroomed, providing job opportunities for those who were good managers. Lastly, the increased number of TVEs and their expansion in scale made it impossible for community governments to obtain full and detailed information about TVEs' operation. Hence, direct supervision became ineffective.

Compared with SOEs, TVEs had two advantages. First, township governments and rural collectives were relatively dependent on TVE development. Community residents were also more concerned about TVEs. The nature of TVE ownership was tangible and real. Second, TVEs never had to bear any burdens imposed by government policies and could therefore carry out reforms without many restrictions. Under such circumstances, the joint-stock cooperative system, which provided managerial personnel with a desirable share of capital, became an effective incentive under the new environment. At the same time, the non-separation of business and government function gave township and village government the right to control TVE's surplus. This control of TVE's surplus became difficult when the information asymmetry between local officials and TVE managers grew serious. The local authorities then needed a stable institutional arrangement to gain a comparatively stable share of surplus from TVE's profits. The worsening of information asymmetry made a new form of supervision necessary. The result was a rapid diffusion of the joint-stock cooperative system.

Since the TVEs faced various problems, and because they differed from each other in terms of their scale, technological level, management, and history, the reform also had to be flexible. Along with the typical joint-stock cooperative system, many other forms have recently come into being, like limited-liability companies, shareholding companies, leasing, selling, merging, asset-value-

adding contracts, conglomerates, foreign joint ventures, and privatization.<sup>17</sup> If the development of non-SOEs represented by TVEs injected vitality into the overall economy in the 1980s, the diversity in the evolution of TVEs' ownership and governance in the 1990s has surely changed the fundamentals of China's rural economy.

---

17. Lu Wen, "The Development of the Property Right System Reform in the TVEs", *Rural Economy in China*, No. 11 (1997).