

A Mid-Course Assessment of China's Economic Reform

By Hang-Sheng Cheng*

President, The 1990 Institute

* - The author wishes to acknowledge the assistance received from numerous persons who commented on earlier drafts of this paper and helped to improve its contents and presentation.

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Executive Summary

China's economic reform entered a new phase in 1994 when the nation launched a comprehensive program designed for completion by the year 2010. This paper reviews past reforms and the problems that have led to the current reform as well as the implementation to date of the new reform program. It suggests that China's rapid economic growth is not sustainable without parallel development of market-supportive institutions, which thus far has been largely ignored. The current reform is intended to correct that. Its success will require less formalism and greater trust in the price mechanism than in the past. The paper concludes with thoughts on China's role in the world economy.

I. Introduction

China's economic success has dazzled the world. Since reform began in 1979, China has maintained the highest output growth rate in the world, attaining an annual average of 12.5 percent from 1992 to 1995. Among the developing countries, it has been the largest recipient of foreign direct investment, amounting to \$38 billion in 1995. Some observers are speculating that China could replace Japan as the second largest economy in the world by the year 2010.

Yet, paradoxically, many respected scholars and policy advisers in China are quite concerned about the country's economic future. In private conversations, they marvel at the outside world's enthusiasm and note, with a smile, how its views have swung from dire pessimism at the beginning of this decade to unbounded optimism a mere six years later, when basically not that much has changed in China.

What is the reason for this contrast in assessment? Are the outside observers naive, as the insiders seem to believe? Or are the insiders only seeing the trees, not the forest, as the outsiders seem to think? What is the true picture of China's economy today and its prospects in the foreseeable future?

This is a particularly opportune time for an assessment of China's economic reform and its economic prospects. China has reached a midpoint in its economic reform. Past reforms have produced rapid output growth and improved the living standard for the majority of its people. Yet, the task is only half completed. Many of the constraints to growth remain, and the underlying foundation for sustainable growth is yet to be laid.

In 1994, China embarked for the first time on a comprehensive and systematic approach to economic reform to be implemented and completed in the next 17 years. The program is particularly helpful for our assessment, as it reflects the scope and nature of the task as the insiders see it. And the program's implementation in the last two years provides insights on the realities in China as seen from this outsider's point of view.

II. Past Reforms and Problems

China's impressive economic progress in the last 17 years is a familiar story that needs no repeating. Instead, three principal features of the reforms that began in 1979 will be sketched to help review the past and assess the present. They are: decentralization, marketization, and financial liberalization.

Decentralization means a devolution of economic decision-making from the central authorities to lower levels of the government. During the 30 years prior to

1979, twice decentralization had been tried, first in 1958-60 and then in 76, both times ending in disaster. The third attempt in 1979 differed in that decentralization this time was extended down to the level of individual production units, rather than stopping at the provincial government level, in a gradually liberalizing market environment

Marketization means the replacement of central planning by the free play of market forces. Internationally, an open-door policy ended 30 years of self-imposed insulation from the rest of the world and opened the economy gradually to competition, new technology, and new markets through foreign trade and foreign investment. Domestically, by 1994 more than 85 percent of agricultural prices and more than 95 percent of industrial consumer prices were free of government control, and the scope of mandatory production planning fell to only 5 percent from 95 percent of total industrial output prior to reform. In addition, the rise of township and village industries and of private enterprises, including wholly or partially foreign-owned businesses, has greatly increased opportunities for entrepreneurship and competition in the economy.

Lastly, financial liberalization means the switch from government-budgeted investment financing to lending through banks. Because in China banking control is much weaker than government fiscal control, the change has significantly loosened the budget constraint on the financing of investment and production.

Together, these three factors released a torrent of powerful productive forces that had been dammed up by central economic planning. Over the past 17 years, this newly unleashed vitality has gathered momentum to create spectacular output growth, especially in the last four years.

The question facing us now is how long can this momentum be sustained.

To answer this question, we must draw a distinction between economic growth and economic development. Economic growth refers to output growth, while economic development refers to the development of public and private institutions and conventions that are essential for sustaining economic growth. A nation can achieve rapid output growth by increasing capital investment and acquiring new technology--as the former Soviet Union did in the 1930s and China in the 1950s--as well as by more efficient use of its resources through domestic and international marketization--as China has done since 1979. But, without developing the essential market-supportive institutions and conventions, output growth will inevitably lead to chaos, wastefulness, and eventual exhaustion of the sources of growth.

This, I believe, is where China stands today. On the surface, everything looks fine: businesses are booming, high-rises are going up everywhere, and foreign capital keeps pouring in. But, internally, both its society and its economy have deep-seated problems.

These problems may be summarized under the same three headings used above to characterize past reforms: decentralization, marketization, and financial liberalization--plus market infrastructure. Past reforms, in each of these areas, carried the signature of a piecemeal, experimental approach. This approach has brought about clear signs of malfunction of a half-market, half-government-controlled economy--with plenty of vitality, but not much rule and order. Pundits have aptly labeled it an economy of the "Wild East."

A. Partial Decentralization

Devolution of business decision-making has not been carried through to all enterprises. For ideological as well as practical reasons, this has been especially true with respect to the state-owned enterprises (SOEs), which to a large extent continue to be directly managed or tightly controlled by various government agencies. However, despite preferential treatment in the supply of energy, transportation, and raw materials, about one-half of the 100,000 SOEs sustained losses in the business-boom year of 1994. Although accounting for only about 40 percent of the nation's total industrial output, they absorbed two-thirds of total domestic credit and received subsidies amounting to two-thirds of the large government budget deficit that year.

The SOE problem is only the tip of the iceberg of a much larger and more general problem of the nation's industrial organization. Virtually all domestic businesses of any significant size are either owned and operated by some government agencies or are indirectly connected with some government units. Though government-related, these business enterprises do not exist to carry out government policies as before reform, but to make money, to get rich, for their own workers and the respective government agencies and their staffs.

Moreover, the majority of businesses are in some way tied to the local government. Local interests often prevail over business interests. Local protectionism in terms of the sourcing of productive inputs, allocation of credit, distribution of tax concessions, and enforcement of court decisions has built up a tight and cozy relationship between businesses and the local bureaucracy.

In this environment, connections reign over productive efficiency as the key to economic success. Corruption is rampant, and influence peddling is a way of life. The cost of doing business in this environment, to individual businesses and the society, is enormous, compared to that in a market economy

Another consequence of decentralization has been the steady deterioration of government finance. The share of government revenue in GDP fell steadily from 34 percent in 1978 to only 14 percent in 1993, compared to an average of 32 percent in developing countries and 48 percent in industrial countries. Inadequate government revenue and the associated perennial budget deficits have meant underfunding of major priority areas such as education, public health, poverty alleviation, environmental protection, transportation, pension reform, and unemployment assistance--with adverse impacts on social stability in the short run and on economic growth in the long run.

B. Incomplete Marketization

Marketization has also been far less than complete. Internationally, although the open-door policy has succeeded in attracting large inflows of foreign direct investment and in developing a dynamic, rapidly expanding export sector, by 1993 the economy was still shackled by a deep-rooted mercantilist mentality of export promotion coupled with protectionism against imports. Almost one-half of imports were subject to licensing, and a high tariff system was structured to favor imports of raw materials and intermediate products against finished goods, resulting in retarded development of domestic high-quality intermediate-product industries and low domestic content of exports. In addition, an exchange control regime coupled with a dual exchange rate added another layer of mercantilist policy to the trade restrictions.

Domestically, marketization has been almost entirely on the output side of the market and little on the factor-input side. Although by the end of 1993, the prices of most goods and services were market-determined, for the factor inputs--land, capital, labor, and technology--there were hardly any markets to speak of. The nation's constitution stipulates that all land is state-owned. Since 1979, farmers have leased land from the state, but the leases are not transferable. Experiments with urban land leases, also non-transferable, are just beginning. Until recently, capital was allocated by state-owned banks in accordance with the credit plan. And the annual volume of capital raised in the emerging capital markets is negligible. Labor mobility is hampered by the household registry

system, which has kept surplus farm labor in the countryside, though with decreasing effectiveness. A more effective barrier to labor movement has been the employer provision system, which still provides to permanent employees cradle-to-grave welfare--including housing, medical care, child education, vacation travel, old-age pension, funeral and burial services. Technology is also not marketable. A patent law was passed in 1985 and a copyright law in 1990, to encourage inventions and innovations. But, enforcement remains a remote hope.

C. Limited Financial Liberalization

The shift from government-budgeted financing of investment to bank financing is a far cry from the deregulation of the financial system in market economies. In fact, after 17 years of economic reform, although central planning of physical production has largely disappeared, until recently the credit plan remained the central guiding principle of credit allocation in China. Under the plan, the central bank directly controlled the total volume and the direction of bank loans to enterprises as well as the magnitudes of individual securities issues in the capital market. Interest rates today are still regulated by the central bank under the direction of the State Council.

The result of this government direct control of all financial activities has been a banking system that operates purely as a government bureaucracy, and a stunted growth of money and capital markets. Despite the phenomenal expansion--in variety and in volume--of financial institutions and financial assets in the last 17 years, functionally finance remains the most unreformed area in the Chinese economy today. Thus, in this partially reformed economy, while most of the prices and production decisions are now market-determined, the all-important allocation of credit and supply of money was until recently still controlled by economic planning.

The incongruity of marketized production and plan-controlled finance has become more evident, as decentralization expanded both the sources and the magnitude of political pressure on the central bank for easy monetary policy. The increased pressure has made the central bank's management of the annual credit plan increasingly difficult. Moreover, as was to be expected, the market has developed many ways to get around the credit plan, in the form of a variety of nonbank financial institutions and informal money markets. The result has been less effective monetary control.

Moreover, under political pressure, the central bank has not followed a stable monetary policy. When it succumbed to pressures and allowed rapid growth of credit and money supply, inflation followed; when it tightened credit and reduced monetary growth, the economy slowed down and pressures for reversal of the policy remounted. The resultant stop-go monetary policy has been the principal cause of China's macroeconomic instability and accelerated inflation during the past 17 years.

D. Inadequate Market Infrastructure

Foremost among the market-supportive institutions essential for sustainable economic growth are law and the court system. Civil law has never had much of a tradition in China. Whatever tradition there had been the Communist revolution in 1949 destroyed almost entirely. The 1979 reform reawakened an appreciation of the importance of law in a market economy. A series of basic laws have been enacted, governing foreign joint ventures (1979), business contracts (1981), trademarks (1982), patents (1984), environment protection (1989), copyrights (1991), corporations (1993), foreign trade (1994), and arbitration (1995).

Efforts have been concentrated on legislation, however, rather than on enforcement. The latter depends on the lower courts and the local police, both of which are either directly under the local government or closely tied to it. Court judgments against local businesses under local governments' protection have little chance of being enforced.

III. Current Reform: Programs and Implementation

Recognizing the problems arising from the piecemeal, experimental approach to past reforms, the authorities in 1994 launched a bold, comprehensive and integrated reform program designed to complete the reform process and construct a "socialist market economy with Chinese characteristics" by the year 2010. It covers a wide spectrum of areas. Instead of examining it in detail, I shall focus on a few areas to illustrate the general characteristics of the program and the difficulties of implementation.

A. State-Owned Enterprises

The authorities recognized the need to complete the decentralization process by insulating the SOEs from government interference and giving them complete autonomy in management. Out of the 100,000 SOEs, 10,000 were selected to adopt new accounting standards, 1,000 large SOEs to adopt new state asset management regulations, and 100 large and medium-sized to be incorporated as shareholding companies operating under their own boards of directors. In addition, 18 cities were chosen to experiment with comprehensive reform programs, including corporate restructuring and municipal provision of social insurance services to workers. Recently, in March 1996, the government announced its intention to concentrate reform on 1,000 large SOEs and dispose of the roughly 90,000 small SOEs through mergers, leasing, or sale.

Given the magnitude and complexity of the task, it is not surprising that progress has been limited. Of the 100 selected for incorporation, 61 have done so, but altering the form of corporate structure is the easiest part of the program. Among the 18 cities selected for reform experiments, several have successfully completed bankruptcy proceedings on loss-making enterprises and laid off hundreds of thousands of workers without incident. However, out of the 100,000 SOEs and the estimated 15 million redundant workers, this is a very small beginning.

B. Housing and Social Welfare

The largest obstacle to enterprise reform has been the employee welfare system, described above, that guarantees the workers cradle-to-grave benefits. These benefits are provided directly by the SOEs and constitute a heavy burden on them, especially in the face of increasing market competition from other types of firms--such as collectives, township-and-village enterprises, and foreign-owned businesses--which are not similarly burdened. To create a level playing ground, the SOEs must be relieved of these burdens.

Reforms in housing, medical care, children education, and old-age pension were started before 1994; some of these have been accelerated since. Besides vigorous housing construction in all major cities, rents have been raised and experiments with sales have begun. Although little progress has been made on medical care and education because of lack of funds, reportedly 70 percent of the urban workers have joined some sort of pension system, and 53 percent are now covered by unemployment insurance. In addition, 50 million rural workers have joined a national rural old-age pension plan. Out of a total rural population of 900 million, this is a mere fraction. Nevertheless, it is a significant beginning.

C. Taxation

Another major component of the reform program is a complete overhaul of the nation's taxation system, launched in 1994. The goal was a modern taxation and revenue-sharing system based on the principles of equality of tax burden, simplicity of tax administration, and buoyancy of tax revenue with the expansion and contraction of the national income. The new tax system introduced a unified single income tax for all enterprises, a broad-based value-added tax (VAT) covering almost all goods and services, excise taxes on a few selected commodities, and a business tax on services not covered by the VAT. Revenue sharing between the central and local governments is now clearly defined, and a national tax administration has been established to collect central taxes as well as tax revenues to be shared with the local governments.

The implementation of tax reform is an enormously difficult task. Old habits of tax evasion are hard to change, and fraud is rampant. For instance, in 1995 the total amount of export tax-refund under VAT exceeded the total VAT collected from their production. The difficulties of implementation are also reflected in the continued fall in the government revenue as a ratio to GDP, slipping from 13.8 percent in 1993 to 12.4 percent in 1994, and 11.3 percent in 1995.

D. Foreign Trade and Foreign Exchange

In its bid to enter the World Trade Organization (WTO), China has reduced its import tariff rates to an average of 23 percent from 40 percent in 1992 and eliminated two-thirds of the import quotas and other quantitative restrictions. In addition, a unified exchange rate was established in 1994 to replace the previous dual exchange-rate system. The exchange rate is now determined by the market through the banks, with central bank participation in the market to help stabilize the rate. Moreover, the onerous foreign-exchange certificate imposed since 1980 on tourist and foreign business spending in China has been abolished. And exchange controls on trade and all trade-related transactions have been removed. Recently, the authorities declared that the national currency would become convertible on all current-account transactions by the end of 1996, thereby making China one of the International Monetary Fund's "Article VIII" member countries.

E. The Financial System

On the domestic side, one of the most important marketization programs is the reform of the financial system. The authorities intend to overhaul the entire financial system in order to free it from vestiges of the old command economy and transform the system into one operated according to market principles. First, the central bank has been given more independence, but still functions under the State Council's direction, in carrying out its responsibilities. Monetary policy is now explicitly aimed at price stabilization. Second, banks and nonbank financial institutions are required to operate on a commercial basis. Policy loans are to be shifted to three policy banks specifically created for that purpose. Third, the central bank is charged with fostering the development of competitive money and capital markets under its supervision and regulation, for the provision of liquidity and efficient allocation of capital.

Thus far, the basic legal framework for financial reform is largely in place. Accounting and auditing procedures for banking operations have been formulated, and staff training programs have been started. The credit plan has been abolished,¹ and an interbank fund market has been restarted under close central bank supervision. The three policy banks: an export-import bank, an industrial development bank, and an agricultural financing and development bank, are in operation. However, the problem of policy loans remains unresolved, and banks must continue to provide policy loans. Interest rates are still regulated by the central bank. And, despite claims of the economy's successful "soft landing" in 1995, the end of stop-go monetary policy is not yet in sight.

F. Law

With the 1994 reform, the pace of legal reform accelerated. The People's Congress set a goal to complete the basic legislation for a "socialist market economy" by the end of the century. In 1995 alone, it passed 13 laws of fundamental importance to the economy, including laws on the central bank, commercial banks, insurance, securities, taxation, corporation, and environmental protection. Also notable were new laws on local election, the court system, the police, education, food standard, science and technology. The rapid increase in the number of lawyers in China is another sign of the growing importance of law in the society. There were 82,000 in 1995 compared to less than 50,000 in 1992 and less than 1,000 in 1980. Progress toward effective law enforcement, however, remains very limited.

IV. Conclusion

The question on China's economic prospect by 2010 can now be answered. The answer is implicit in the analysis above. Nonetheless, it is useful to make it explicit, together with a consideration of China's role in the world economy.

First, economic growth is not the same as economic development. In the past 17 years, China has achieved rapid economic growth, but made little progress in economic development. Without the essential parallel development of supporting market institutions and conventions, eventually the economic costs of growing chaos and wastefulness will override whatever remains of the economy's growth potential.

Second, the comprehensive reform program launched in 1994 reflects the authorities' recognition of the numerous basic deficiencies in the economy, requiring correction. In the last two years, considerable progress has been made in foreign trade and foreign exchange liberalization, the development of a modern tax code and revenue-sharing arrangements, as well as in social and economic legislation. However, despite these impressive achievements, enormous difficulties continue to confront enterprise reform, housing and social welfare, tax administration, financial reform, and law enforcement.

Hence, the answer to the question posed in this paper must be a conditional one: China's output growth is sustainable into the next century, say, to 2010, if and only if it succeeds in implementing its current comprehensive reform program. Predictions of China's becoming a great economic power by the year 2010 are greatly exaggerated. At best, it could become another newly industrialized country. Nevertheless, because of its sheer size China remains an attractive market for businesses that are experienced in trading with or investing in developing economies.

As an extension, I shall attempt a few cursory remarks on two additional questions: First, what will determine the outcome of the current reform program? And second, what should be China's role in the world economy?

On the first question, it would seem premature to hazard any judgment on the prospects of the reform program's outcome as it was launched barely two and a half years ago. Yet, I cannot help but be impressed by the earnestness and vigor with which the program is being implemented. Progress has been made, and a solid foundation is being laid. Nonetheless, this outside observer fears that in the program's implementation, again formalism might reign over substance, and certain basic errors in economic thinking might continue to obstruct progress. A few examples will suffice to illustrate each of these two fears.

Formalism. An obvious example is law. It is both necessary and commendable to design and pass the large number of basic laws as the national legislature has

done in recent years for the regulation of economic and social activities. But, without effective enforcement the effort will be of little avail. When this problem is raised in discussions, too often one hears in reply rationalization in terms of the enormity of the task involved. One understands and sympathizes, but cannot help but wonder what concrete action plan is being prepared to improve enforcement. A gigantic political commitment, comparable to the launching of the current reform program in 1994, would be necessary to get such an action plan started.

Errors in Economic Thinking. After 17 years of successful reform, the authorities still retain some remnants of distrust of the price mechanism. As stated, most of the prices have already been freed of government controls. But, it is in the remaining areas deemed by the authorities to be of critical importance to the national economy that price controls still remain. These areas include basic materials, such as steel and cotton; energy, such as coal and electricity; transportation, such as railroad; staple food, such as grains and edible oil. Policies designed to ensure their plentiful supply at low prices are precisely those that retard production, contribute to shortages, and add to the burden of budgetary subsidies. Administered interest rate is another example of misconceived policy that distorts credit allocation and thwarts the development of money and capital markets in China.

Finally, on China's role in the world economy, the nation's open-door policy has contributed greatly to the success of its economic growth but, at the same time, exposed its economy to the vicissitudes of the world economy and world politics. That is the price of being a member of the world community. Like all other members, China too must be prepared to accept the rules and obligations of the community--both in form and in spirit.

Moreover, because of its size and influence in the world economy, China ought to take on a more active role in helping to shape the rules of the world community. After the break-up of the Soviet Union in 1990, the world community has been in flux. A post-Cold War new world order has yet to emerge. China could and should play a significant, constructive role in the development of that order.

For its part, the rest of the world must recognize China's potential role and actively encourage and assist China to participate in the construction of a new world order. To this observer, a policy of threat and confrontation has proven to be counter-productive. The sooner an effective alternative approach is adopted, the better will it be for China and the rest of the world.

Endnotes

1. Recently, sources within the People's Bank of China, the nation's central bank, indicated that the credit plan was abolished in early 1995. Curiously, no public announcement has been made. Information on this important policy shift is too scanty to permit analysis at this stage.