

China's "Dual-Track Transition" Toward the Market: Achievements and Problems

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Introduction

After three years of "rectification" and recession, in 1992 China again dramatically impressed the world with a 12.8 percent growth rate and further acceleration toward a market economy. That same year, the ruling Communist Party adopted a "socialist market economy" as the official goal of China's economic reform. The country's economic success may appear puzzling. The political regime has remained unchanged, and the state sector continues to dominate the economy. At the same time, non-state sector businesses are booming everywhere, and the market is beginning to work in most economic areas.

This paper attempts to solve the puzzle. Using the economic restructuring that has taken place in China in the last 15 years as a context, we will try to explain the fundamental features of China's gradual market-oriented reform and the problems this gradualism has created for future reformers.

I. China's Changing Reform Objectives

China's reform has not been guided by a well-defined, well-determined objective model. This lack of a clear model contrasts with the experience of the Poles who, as an overwhelming majority, were quite clear about their need to "go back to Europe," and that of the Russians who, also as a majority, were quite determined to adopt a private market economy when their "radical reform" began in the late 1980s. Neither the Chinese leadership nor the majority of Chinese people had any clear idea of how to proceed with economic reform in the late 1970s. All they knew was that the conventional centrally planned system did not work well and that some changes were necessary to promote economic growth. That is, they recognized the need to "introduce some market elements into the economy." Most households and individuals in China had not completely lost their faith in the old system, perhaps because unlike Eastern Europeans, the Chinese were not suffering a zero or negative income growth. (The national income growth rate in China was as high as 7 percent in 1977 and 12 percent in 1978.)

The "elites" in China believed that given a chance to run the economy "more scientifically" like their Soviet counterparts, they could easily solve the country's economic problems. (In fact, the Chinese technocrats had little chance to carry out their economic "plans" prior to 1978 because of the frequent political turmoil that gripped the country beginning in the late 1950s.) The Cultural Revolution not only grievously damaged the economy, but it also convinced many policymakers that the most important problem was the "failure to concentrate on economic construction" rather than basic structural defects in the system. To many people, the noticeable improvement in economic performance after the Cultural Revolution was evidence of the virtues of the old system. Consequently, the Chinese did not initiate "radical" measures at the outset of their economic reform.

Continued belief in the old system did not prevent China from moving in the direction of market-oriented reform. Since 1978 the majority of Chinese leaders have agreed on "introducing more market mechanisms" into the economy. The problem has been a lack of consensus on defining the "market" and its institutional requirements. As a result, the reform objectives have been readjusted many times, from "a planning economy with some market adjustment" and "the combination of planning and market" to the current "socialist market economy." Obviously, defining the new objective is still highly controversial and will be further debated and modified.

II. The "Dual-track System": How to Avoid Resistance to Economic Reform

The so-called "dual-track system" was first introduced in price reform, but it actually had been used extensively in most reform areas, including urban reform, foreign trade reform, labor reform, housing reform, social security reform, and most important, ownership reform. "Dual tracking" refers to adopting some aspects of a market economy while simultaneously operating under the old planned economy regimen.

Transition from a planned economy to a market economy through the dual-track system reflects the most fundamental characteristic of Chinese economic system reform--developing the elements (or sectors) of a new system side by side with the old unreformed system, and then, if things go well, reforming the old system in line with the positive developments emerging from the new components of the economy. This reform strategy may not be justified by "eliminating efficiency loss" or "minimizing the implementation costs" of the reform, but may be rationalized by reducing the costs of political conflict the reform may generate in the real world.

Economic reform involves a rearrangement of economic relations among various interest groups. In general, it would not be a "Pareto improvement" if somebody were worse off following such a rearrangement. A well-designed "compensation" program may help to buy out those who oppose the reform because of their potential loss, but the effectiveness of the compensation theorem is limited in practice by at least two factors. (1) As long as "relative income" is taken into consideration, "full compensation" produces no improvement in the incentive structure because relative income remains the same. (2) In the dynamic reality, people often cannot be compensated promptly by "reform profits" because the new economic institutions and arrangements may not yield "reform profits" in the short term.

In general, reforming the old system necessarily produces resistance from various interest groups that would suffer losses. From this point of view, the different approaches to economic reform are simply different ways of dealing with the resistance to reform. The "radical approach" breaks down the old system, no matter how high the costs of overcoming the resistance of various interest groups. At least two conditions are necessary for radical reform to succeed: (1) the majority of society accepts a well-defined reform objective, and (2) the pro-reform groups are strong enough to make their radical program survive the political conflicts. An economy in which these conditions do not exist is likely to choose the incremental approach. The "incremental approach" develops the new institutional arrangements without breaking down the old system immediately, thereby reducing the resistance from groups whose interests are preserved temporarily until conditions for reform improve. This approach posits that if the "old track" is too difficult to abolish, it would be better to develop the "new track" first and have it parallel the old one. Such an economy may suffer higher efficiency losses and pay more for completing the reform programs because the old system will exist longer before it is eventually transformed. On the other hand, this economy may not pay high political costs in the form of additional reduction of national income caused by severe social and economic chaos at the initial stages of the reform.

China adopted the incremental approach both because of a lack of clear-cut reform goals and because of a lack of strong pro-reform groups within its political power structure. Factoring "resistance" into the cost-benefit calculations, the "best" choice for Chinese reformers may have been to begin with some market-oriented moves that would generate less resistance. Compared to Russia and Eastern European countries, China has so far not suffered much social chaos and economic disorder. This is not because China lacked resistance to the economic institutional changes. It is because no radical program could be adopted under the great pressure of anti-reform forces. The only program that could pass was one that did not destroy the old economic relations at the early stages of the reform.

This realization may shed some light on the question of "reform sequencing." The fundamental guideline for sequencing incremental reform is to introduce reform in the sectors or areas of least resistance, not necessarily in the largest sector. In China, that sector was agriculture. China began its economic reform in agriculture (which happened also to be the largest sector) because that sector was the easiest place to carry out reform policies. In contrast, radical reform specifically attacks the "hard cores" of economic institutions from the very outset. Also in contrast to gradualism, which focuses first on economic reform, the radical approach targets political reform before economic reform. This difference is not surprising given that political reform is in essence the process through which pro-reform groups take actions to overcome resistance from those whose interests lie with the old system. When pro-reform groups are not strong enough to overcome that resistance, either no economic reform takes place at all (as happened in the Soviet Union and some Eastern European countries prior to 1989) or economic reform goes first through the dual-track transition.

III. The Major Achievement of China's Economic Reform: The Development of the Non-state Sector

To date, the most significant achievement of China's dual-track transition has been the rapid development of the "new track," i.e., the non-state sector, which includes rural collective industries, urban corporations, private and individual businesses, and foreign joint-venture companies. Another noteworthy achievement and a more traditional measure of the success of economic transition has been the gradual abolition of price controls, which according to some researchers remain on only 10 percent of China's consumer goods sales and 30 percent of its producer goods sales.

Three institutional changes allowed the development of the non-state sector in China: (1) rural reform, (2) urban economic liberalization, and (3) opening to the outside world.

1. Rural reform. By the end of 1983, 98 percent of rural households in China had signed contracts with local collective economic authorities, which remained the landowners. Since then, household farming has replaced collective production in China, and rural residents can pursue their own interests by conducting a variety of business activities besides farming. The liberation of many rural laborers from the land has given impetus to the development of market-oriented rural industries, mainly in the form of township and village-owned enterprises (TVEs) outside state planning control. By the end of 1992, the total output value of TVEs accounted for as much as 32.2 percent of the total output value of the society and 35.6 percent of total industrial output value. More than 24.2 percent of the rural labor force worked in TVEs. The growth of TVEs has not only significantly eased the problems of unemployment and urban congestion in China but also contributed a great deal to the development of a market system there.

The enormous amount of rural surplus labor is a special condition in China that favors the development of the non-state sector. It allows China to move ahead with the incremental approach without having to reform the state sector to liberalize and reallocate labor from the old system to the new.

2. Urban economic liberalization. Since the early 1980s, private and individual economic activities have no longer been illegal in China, although discrimination has remained. The dual-track system gave people economic opportunities in the non-state sector. The pressure of urban unemployment prevented the government from going too far in restricting the expansion of private business. Newly developed high-tech industries such as the computer industry also provided special room for the growth of non-state corporations.

So-called "official speculation" or "rent-seeking" activities under the decentralized public ownership economy and the dual-track price system also contribute to the development of the non-state sector. A case can be made for the positive effects of this "rent-seeking" activity under the dual-track system. When officials shift goods from planned sales to the market, they reduce the actual coverage of planning control and expand the non-plan business, thereby extending the scope of the market. Unproductive profits from rent-seeking from corruption and stolen state assets have been important sources of initial capital accumulation for non-state enterprises in China. When Chinese officials are operating their own non-state businesses, either openly or underground, they may have difficulty prohibiting or restricting others from doing similar things. From this perspective, "bureaucrat capital" is an undesirable but inevitable part of the dual-track transition process and is not without some positive consequences.

On the other hand, one could argue that there are better (less costly) ways of expanding the scope of the market, e.g., legalizing the rights to transfer property, and that even if one can morally justify stealing by documenting that the stolen money is used to benefit the economy, the legal issue cannot be skirted. Moreover, corruption may work against reform in several ways. It may block the evolution of the economy toward a one-track system by perpetuating the dual track. The positive effects of marketization may be offset by the higher transaction costs caused by corruption. Officials may attempt to monopolize their gains rather than share them. As a result of large unearned incomes accruing to corrupt officials, the chance of political instability may actually be heightened. Finally, corruption undermines the building of an effective legal system. In sum, while corruption is not totally bad, it does adversely affect economic reform.

3. Opening to the outside world. Foreign investment not only brings in capital and technology for economic growth, but it also boosts the development of non-state enterprises, especially joint ventures and share-holding corporations. As a result, the industrial output value of the non-state sectors as a proportion of total industrial output value increased from 22.4 percent in 1978 to 51.9 percent in 1992. About half of the total output value of society as well as up to 60 percent of GNP was generated by the non-state sector in 1991.

Many shortcomings exist in the operations of non-state enterprises. Ownership is still not well defined in many collectively owned TVEs, giving rise to problems of undivided, untransferable, nontradable public ownership. Local government interference becomes more frustrating when the business grows into an important source of local government revenue. Numerous illegal practices such as bribing can be observed especially in the early development of private sector activity.

Despite these shortcomings, fundamental behavioral differences exist between non-state and state-owned enterprises. For example, when a TVE fails in market competition, it cannot shift its liabilities to the state budget and rely on state subsidies to survive. It also cannot borrow further from the banking system, as state enterprises usually do, after failing to repay previous debts. A bad loan is a bad loan, but a TVE or private business cannot continue to accrue bad loans. The non-state sector still may not be very technically efficient in terms of input-output ratios, but it is more efficient in terms of financial performance and macroeconomic stability. The growth of non-state industries also provides more favorable conditions for the reform of the state sector: it creates job opportunities, which make it easier to employ the surplus labor of the state sector; it pushes the state enterprises into market competition and breaks down the state monopoly; and it keeps the national income growing, making it possible to compensate those who suffer temporary losses in the economic

restructuring of price and enterprise reform. From many points of view, it was the non-state sector that made the market mechanism begin to work in China and that has kept the economy growing dynamically for the past 14 years. It can be predicted that the success of China's incremental reform will rely on the further growth of the non-state sector and further enlargement of its importance in the national economy. More favorable policies should be adopted to promote this development.

IV. The Major Remaining Problem: The State Sector

The fundamental problem with dual-track transition is that it keeps the old system intact for a long time, thus preventing quick elimination of economic distortions and efficiency losses. After 14 years of reform, most of China's major economic problems are related to the existence of a state sector that is still dominant in most industrial sectors. To date, reform in the state sector has confined itself to the "decentralization" of decision-making powers; little has been done to restructure ownership. Decentralization within state ownership provides more incentives and autonomy for managers and workers to pursue their own interests. However, no strong evidence verifies improvement in technical efficiency in terms of input-output relationship in state-owned enterprises (SOEs) since the reform.

Meanwhile, one can observe a deterioration in the dynamic efficiency of the economy in the last decade: the profit rates of SOEs have declined and the number of loss-making enterprises increased; inflation has soared; the economy gets overheated easily; the amplitude of macroeconomic fluctuations has magnified; the state has begun losing its ability to implement effective stabilizing policies; and the cycles of "decentralization-recentralization" of decision-making powers, which have accompanied business cycles, have created additional difficulties for the institutional transformation.

Since 1992, a "new wave" of decentralization has swept the state sector. Not surprisingly, the economy has begun heating up again and going into a similar cycle as before. Many people, especially some government officials, still believe that granting more autonomy to state enterprises and local governments without changing the ownership structure would resolve the problems faced by the state sector and the economy as a whole. However, more and more people are abandoning this hope as they observe recent economic events. The key question now is how to prevent the capital from being abused in a decentralized state-owned economy in which no individual really fights for the interests of the capital and no one is responsible for the capital loss.

The relative importance of the state sector in the Chinese economy is shrinking. As long as we consider differences between the state and non-state sectors in economic efficiency, competitive capacity, and the speed of growth, the dual-track transition will result in an elevation of the role of the non-state sector. Capital assets and skilled workers will shift from state enterprises to non-state businesses sooner or later (for a variety of reasons including less positive ones like "stealing" or "spontaneous privatization"). Nevertheless, a more active and dynamic reform program for changing the ownership structure is needed to more efficiently use state assets to speed up economic growth and to make the institutional transformation smoother, healthier, and fairer. Ownership of state assets should first be clearly defined to make it transferable and tradable; state enterprises then should be converted into corporations with at least some stock shares distributed among workers and managers. Corporatization does not necessarily mean privatization, but it will provide a more flexible mechanism for further ownership changes.

Ownership reform is at the core of economic system reform in China. Ownership reform will not only encounter strong resistance but also be technically difficult to implement. The sooner and more aggressively actions are taken to improve conditions for conducting ownership reform, the lower the costs of the transition. China's economic reform cannot completely succeed until major reform of the ownership structure is undertaken in the state sector.

About the Author

Professor Fan Gang is deputy director of the Institute of Economics, Chinese Academy of Social Sciences (CASS) in Beijing and has been a research fellow at the same Institute since 1992. He received his Ph.D. in economics from the Graduate School of the Chinese Academy of Social Sciences in 1988. Dr. Fan was the Chief Editor of *Jingji Yanjiu* (Economic Research Journal) from 1992-1993 and a visiting fellow of the National Bureau of Economic Research in Massachusetts from 1985 to 1987.

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