

## Cato Institute Policy Analysis No. 95: Modernizing Markets in Post-Mao China: On the Road to Capitalism?

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### Executive Summary

Today's China is vastly different from the China of 10 years ago. Voluntary exchange plays a greater role in the allocation of goods and services. The rhetorical scaffolding of communist central planning has been giving way to private contracting and the entrepreneurial spirit. In short, the Chinese are rediscovering the market.

Since the death of Mao Zedong in September 1976 and the subsequent repudiation of the Gang of Four, China's economy has undergone a sweeping revision. The Chinese experimented with the principles of Marx, Lenin, and Mao; now they are exploring the principles of mutually beneficial trade. About 80 percent of China's retail stores, restaurants, and service shops are now privately owned. Private plot use and contracting arrangements and a greater division of labor have permeated China's agricultural sector. Today over 22 million peasant households--about 14 percent of the rural population--specialize in the production of one crop.

Along with a rising standard of living, consumers have begun to experience freedom of choice. For example, Nonfang Daxia, Guangzhou's largest department store, offered its customers 6,000 varieties of goods in 1978. Today it offers more than 30,000. Pierre Cardin cosmetics are manufactured in several Chinese cities. Pepsi-Cola recently built its second plant in China, a \$4 million investment. The popular communist ideology that has prevailed since the founding of the People's Republic in 1949 has recently been losing ground to a more realistic, pragmatic approach to economic affairs. And in general the people are better off.

Since 1978 Deng Xiaoping, the main architect of the change, has explicitly rejected Mao's "politics in command," which brought about such bloody excesses as the Great Leap Forward and the Cultural Revolution. By replacing "politics in command" with "economics in command," Deng hopes to pull China up from its peasant backwardness. Agriculture, industry, science and technology, and national defense have been slated for "modernization," the aim of which is to transform China into a socially and economically advanced country within the next 30 to 50 years.

The vehicle for economic development in China is a greater reliance upon free exchange and the import of science, technology, and management practices from the West. Indeed, the Chinese realize that much can be learned from Western experience, as Hu Qiaomu, president of the Chinese Academy of Social Sciences, has acknowledged:

Only when we merge the superiority of the socialist system with the advanced science and technology of the developed capitalist countries and their advanced managerial experience, only when we combine what is useful in foreign experience with our own specific conditions and successful experience can we . . . speed up the tempo of the Four Modernizations.[1]

The Chinese do not claim, "We are all capitalists now." Instead, as Deng has said, the reforms are a way of "perfecting communism through capitalism." [2]

But just what does "perfecting communism through capitalism" mean? Such phrases, along with Deng's initial quick pace and subsequent slowdown in implementing the reforms, have led observers to speculate on the degree to which the Chinese leadership will embrace free-market capitalism. Many share an opinion voiced in a 1984 article in the *Economist* entitled "The Retreat from Marx": "The centrally planned economy of Marx, Stalin, and Mao is to be stopped in its dirigiste tracks and put on the market road; the traffic, if good intentions hold, will now be regulated by profits and prices rather than by bureaucrats in Peking." [3] Others, however, are harder to convince. After all, they ask, what incentives do the firmly entrenched bureaucrats have to dismantle the central planning apparatus? It is hard for those bureaucrats to get excited about economic efficiency when their own positions are at stake.

In light of the above, it is natural to ask the following: Is the post-Mao era truly a transition toward free-market capitalism, or is it yet another nominal "rightward" shift in the swinging pendulum of the Chinese Communist party, to be offset in the future by more drastic elements of plunder by the radical left wing? That only time will tell is a true but wholly unsatisfying answer. One thing, however, is clear: since the beginning of 1987 the reforms in China have lost their momentum. A March 1987 issue of the *Economist* spoke of "The Fading in China": "The past three months have been a bitter reminder that, when obliged to choose between pressing ahead with reform and keeping the party's grip over policy, any communist leader is liable to see the case for putting reform second." [4]

It is not that the party leaders are dizzy with success. Indeed, the opposite may be true: the development of a stronger, more rational economy has created much strain in the political hierarchy. A strong central party destroys an economy, whereas a strong, rational economy weakens a party. What will the planners do when millions of independent plans are successfully coordinated in the market? Perhaps the party has become aware of that dilemma. To understand the current situation, we must understand the nature and history of China's economic reforms.

### **The Responsibility System in Agriculture**

Eighty percent of China's population are peasants. Not surprisingly, agriculture plays a key role in China's political economy. Before his rise to leadership in 1949, Mao recognized that "the peasant question becomes the fundamental question of the Chinese revolution, and the force of the peasantry is the main force of the Chinese revolution." [5]

But Mao's violent actions nearly destroyed the country's agricultural base and the loyalty of the peasantry. The seizures undertaken during the land reforms of the early 1950s, along with the bloody forced collectivization of the countryside during the Great Leap Forward, brought about disastrous consequences. Instead of stimulating the peasantry and accelerating China's economic growth, they created a terrible economic failure. [6] A period of readjustment followed between 1962 and 1965, during which private plots were reintroduced to some extent. But that short-lived phase was offset by another burst of extreme left-wing frenzy, the Cultural Revolution, between 1965 and 1976. For ideological reasons, prices were frozen during the entire period, which nearly strangled the economy.

Agriculture nevertheless has remained the foundation of China's economy, providing roughly 70 percent of its industrial raw materials, 80 percent of its domestic consumer goods, and 60 percent of its exports. [7]

Mao's death in 1976 opened the way for pragmatic policies designed to stimulate economic growth, with ideological concerns apparently taking a back seat. China's new leaders recognized the importance of increased productivity in the agricultural sector to overall economic development on December 22, 1978, during the third plenary session of the 11th Central Committee of the Chinese Communist party. The plenum established three policies designed to stimulate agricultural production and improve the terms of trade between agriculture and industry: (1) increasing the state's procurement price for mandatory purchases of grain by 20 percent; (2) raising the above-quota (premium) price by 50 percent; and (3) reducing the prices of certain farm inputs (such as machinery, fertilizer, and insecticides) by 10 to 15 percent.

The most noticeable introduction of marketlike mechanisms came by way of the responsibility system. Previously the peasants' incomes were determined, in the socialist spirit, by a work-point system. A peasant was awarded a certain number of points for each day he worked, and his annual income was based on the total number of work points he

earned over the course of the year. That gave him a great incentive to shirk, because the quality of his labor was not taken into account.[8] The responsibility system, however, raises the personal costs of shirking by altering property rights assignments.

Instead of making the commune responsible for its farming activities, the new system places responsibility in the hands of smaller units such as work groups and households, who must contract with the commune. Each work group or household is responsible for meeting its contracted share of the state's production quotas as well as paying its share of the agricultural tax (in cash, no longer in kind) and the cost of feed for collectively owned livestock. In addition, investments and cultivation practices are left to the discretion of each work group or household.[9] The peasants are largely free to decide what to do with any surplus they produce.

Although land is still legally owned by the state, the right to use land has been assigned to the lessee. That de facto policy was officially acknowledged at the Communist party's 13th Congress in October 1987. Du Runsheng, director of the Research Center for China's Rural Development, said that the government was thinking of legalizing the purchase and sale of the right to use farmland yet insisted, "We will not introduce private ownership." [10] But from an economic point of view, land has essentially been privatized. Although it is legally referred to as collective property (clearly for ideological reasons), it nevertheless exhibits a fundamental characteristic of private property--it is controlled through contracting and subletting. A peasant can effectively sell his property interest in the means of production and enjoy whatever increase in the value of that means of production has accrued as a result of investments and improvements he made in the past. As Steven N. S. Cheung pointed out, "The so-called 'responsibility contract,' if reduced to its simplest and therefore most perfect form, is equivalent to the granting of private property rights via a state lease of land." [11] Hong Kong is another highly successful instance of such a system.

Although private plots were allowed in certain regions of China at certain times prior to 1978 (and accounted for 5 to 7 percent of the country's cultivated land), since 1978 their number has more than doubled in some areas; they accounted for 10 to 15 percent of the cultivated land by the early 1980s. In addition, peasants now engage in such private activities as transporting the crops to the cities and operating pushcarts, food stands, and the like. Private suppliers of agricultural goods are allowed to compete openly with state distributors.

Hence, the responsibility system and the expansion of private plot use are encouraging higher outputs by linking income with productivity and economic responsibility. Peasants are essentially becoming residual claimants in their productive efforts. Through the responsibility system, the leadership hopes to break the Iron Rice Bowl of pre-1978 China, a system characterized by "everybody eating from the same pot," regardless of an individual's contribution. That represents an important shift away from the egalitarian ideals of Maoism; because entrepreneurial and agricultural skill levels vary widely among the peasantry, tying income to productivity necessarily results in differing income levels. The Chinese leadership has explicitly acknowledged that effect. Said Du Runsheng, "We will not let the idea of equalitarianism prevent some peasants from becoming more prosperous before others. Rather, we encourage some to become better off first through their own hard work. If we discourage this everybody will remain poor." [12]

### Benefits from Agricultural Reforms

The results of China's agricultural reforms have been rather astonishing. For example, as reflected in Table 1, the average annual rate of increase in gross agricultural output value was 7.5 percent between 1979 and 1982, in contrast to an average of only 3.8 percent between 1953 and 1982.

In areas where the responsibility system had been implemented or cropping patterns had changed, productivity skyrocketed between 1979 and 1981. For instance, in Shandong, Siquan, Honan, Anhui, and Guangdong the real increases in gross agricultural output value between 1979 and 1981 were 15, 17, 19, 30, and 54 percent respectively. [13] The rate of increase in the gross value of agricultural output grew from 9 percent in 1978 to 11 percent in 1982 and 14.5 percent in 1984. [14]

<b>Table 1</b>			
<b>Growth of Chinese Agricultural Output Value, 1952-82</b>			
			Avg. Annual %

	Increase				
	1982 as % of 1952	1982 as % of 1978	1982 as % of 1981	1953-82	1979-82
Gross agricultural output	306.6	133.5	111.0	+3.8	+7.5
Grain output	215.6	116.0	108.7	+2.6	+3.8
Cotton output	275.9	166.0	121.3	+3.4	+13.5
Output of oil-bearing crops	281.8	226.5	115.8	+3.5	+22.7
Sugar cane output	518.3	174.7	124.3	+5.6	+15.0
Sugar beet output	1,401.3	248.4	105.5	+9.2	+25.5
Tea output	484.1	148.2	116.0	+5.4	+10.3
Fruit output	315.7	117.4	98.9	+3.9	+4.1
Pork, beef, and mutton output	399.1	157.8	107.1	+4.7	+12.1
Output of aquatic products	309.0	110.7	111.9	+3.8	+2.6

Source: Statistical Yearbook of China 1983 (Hong Kong: Economic Information Agency, 1983), p. 10.

However, not all of the increase in output can be attributed to the responsibility system. A simple principle in economics states that a greater supply can be encouraged by raising the price of a good. The 1979 price adjustments increased the quota procurement prices for grain, cotton, oilseeds, and pigs by 20.9, 15.2, 25.0, and 24.6 percent respectively; they also increased the ratio of above-quota prices to quota procurement prices, which rose from 30 to 50 percent for grain and oilseeds. The ratio was set at 20 percent for bast fibers and 30 percent for cotton, neither of which had previously enjoyed an above-quota premium. As a result, the procurement of grain, cotton, oilseeds, and pork increased by 35, 37, 146, and 142 percent respectively for the 1978-81 period.[15] By 1983 the harvests in some areas were so large that an estimated 90 percent of the total farm output was purchased at above-quota prices that year. The state purchased an "extra" 22.3 million tons of grain and 1 million tons of cotton.[16]

More recently, however, China's agricultural output has been erratic. Although it increased at an average annual rate of 11 percent between 1981 and 1984, it increased only 3 percent in 1985. The production of grain, which enjoyed record harvests between 1981 and 1984, fell 7 percent in 1985 as a result of reduced acreage, poor weather, and the elimination of the quota procurement (which had been replaced by contractual agreements with the state).[17]

The agricultural reforms were also designed to change the mix of agriculture, light industry, and heavy industry. Between 1953 and 1978 the total value of the agricultural and industrial production accounted for by agriculture alone decreased at an average annual rate of 1.12 percent, while light industry rose at an annual average of only 0.13 percent. Heavy industry, however, climbed at an average of 25.8 percent. That overemphasis on capital accumulation proved to be detrimental to the standard of living among the peasantry.

The reforms have been successful in changing the mix. In 1978 agriculture accounted for 27.8 percent of the aggregate, and in 1982 it accounted for 33.6 percent; during the same period light industry (also targeted for growth) increased from 31.1 to 33.4 percent and heavy industry dropped from 41.1 to 33.0 percent. By 1982 the average per capita net income of peasant households had doubled that of 1978, while that of urban households had registered a 38.3 percent increase in real terms.[18] However, some statistics show that the peasants working in the fields earn almost one-third less in annual income than those working in the local factories.[19]

## Reforming Industry

Besides agricultural reforms, 1978 marked the beginning of an ambitious series of industrial reforms. Mao's immediate successor, Hua Guofeng, set out a 10-year plan under which annual steel production was to double to 60 million tons by 1985 and reach 180 million tons by 1999. Coal production, which provided 70 percent of the country's energy, was targeted for a doubling to 900 million tons a year; crude oil production was to be increased from 104 million tons in 1978 to 500 million tons by 1985; cement production was to be increased from 65.2 million tons to 100 million tons.[20] A Renmin Ribao newspaper report on March 9, 1978, claimed that the modernization of industry would by the end of the century have enabled China's output to "approach, equal, or outstrip that of the most developed capitalist countries." [21]

But the original 10-year plan proved to be overly ambitious. The ascendancy of Deng brought major "readjustments" to the plan that necessitated postponing or even canceling contracts made with foreign investors, at a cost of over \$1 billion. The steel industry was hardest hit by the readjustments; the two most important prospective projects, the Chidong and Boashan mills, were respectively "indefinitely postponed" and cut back from a planned capacity of 6 million metric tons of crude steel to 3 million metric tons.[22] Those readjustments represent a shift of priority from heavy industries such as coal and steel to light industries such as textiles, China's leading light industry.

The crux of the new industrial reforms consists of granting more discretion and autonomy to China's state-owned enterprises. Instead of relying upon Soviet-style material balances planning, China has been attempting to introduce the use of profit as a material incentive for managers as well as a beacon of economic efficiency.[23] On May 10, 1984, enterprises were given greater autonomy and permission to expand their market arrangements in a statement issued by the state council. The council announced that after fulfilling state plans and quotas, enterprises would be allowed to produce "whatever is needed or in short supply." They may also sell products whose supply is in excess of the quotas and those that have been refused by state purchasing agencies.

Furthermore, enterprises may either set the prices for the means of production within 20 percent of the state prices or negotiate the prices with the purchasers. They are free to purchase raw materials directly from producers; they no longer have to purchase resources through the state monopoly. They are also free to plow profits back into expanded production, innovation, reserves, or workers' welfare funds and bonuses. They have the right, within certain limits, to lease or transfer capital assets. Finally, the factory managers do the hiring and firing of cadres (groups of administrators who belong to the party) below them, the managers themselves being "appointed by the higher competent departments concerned." They may adopt wage systems consistent with state standards and are free, within limits, to adjust wages (which had been frozen for about 20 years) according to worker productivity. Such are the "rights" issued by the state council.[24]

The new reforms are an attempt to develop more-marketlike relations both within and among enterprises. As the administration becomes more decentralized, enterprise managers enjoy greater flexibility in planning. By allowing businesses to shop around for suppliers of raw materials, thereby bypassing central bureaus, the state has in effect been making legal what had always existed--a black market for scarce resources.

The decision to "substitute taxes for profits" was made official by the third plenum of the 12th Central Committee on October 20, 1984. Prior to the reforms, enterprises remitted their profits to the state.[25] Now medium-size and large enterprises pay a tax on the profits they earn and enjoy some freedom of choice in the allocation of the profits.

The tax, however, is not simply a function of profit but depends on the nature of the industry and the product being produced. For instance, the mining industry has been subjected to a resource tax in order to offset differences in land rents, and a product tax has been levied to reduce the high profits enjoyed in such industries as those producing consumer durables, cigarettes, and liquor.[26] Finally, a firm-specific adjustment tax has been levied on the intraindustry level to absorb any "undeserved" profits. When all is said and done, an enterprise can retain about 3 to 5 percent of its profits on sales fulfilling the state quota and up to 20 percent on above-quota sales. [27]

Although the reforms allow enterprises to produce for profit in an arena of increased autonomy, the Chinese leadership insists that they are pragmatic rather than ideological because they aid in the collection of information regarding the efficiency of state-owned operations. The Central Committee noted in 1984,

Since social demand is very complex and in a state of constant flux, since the conditions in enterprises differ in a

thousand and one ways and since the economic links between enterprises are complicated, no state institution can know the whole situation fully and cope with everything in good time.

That is why, within the limits of the state's plan, enterprises are allowed to develop production policies, supply sources, and marketing techniques, to hire and fire personnel, to contract wages, and to price their products.

In short, the enterprise should be truly made a relatively independent economic entity and should become a producer and operator of socialist commodity production that is independent and responsible for its own profit and loss and capable of transforming and developing itself and that acts as a legal person with certain rights and duties.[28]

Knowledge about production techniques, resource availability, managerial expertise, and so on is difficult to attain and is best communicated through the competitive marketplace. Of course, such economists as Ludwig von Mises and F. A. Hayek made that point over 50 years ago. Now the Chinese are beginning to agree. As a piece in the Guangming Ribao stated, "How can an enterprise know about the complicated social needs without relying upon the market?"[29]

Profit-oriented production is intended to dethrone the rigid system of management in which a manager's sole concern is to fulfill the state quota, and to provide an incentive for him to be concerned with such important factors as quality, variety, consumer demand, and economic efficiency. Hence, workers are paid more according to productivity than according to the number of days worked and are subject to demotions and dismissals, no longer enjoying the "once hired, never fired" routine. The attempt, in short, is to create a new incentive system that will smash the Iron Rice Bowl.

### **Special Economic Zones**

By far the most notable operation of the free market is found within the confines of the special economic zones. Since 1980 SEZs have been created in Shenzhen, Zhuhai, Shantou, and Xiamen--an unprecedented step for China. Chosen primarily because of their locations' exceptional suitability for international transport and their long-standing tradition of overseas interaction, the four zones are seen by Chinese leaders as "filters between China's socialist system and the capitalist world, . . . taking in positive things and sifting out negative aspects of Western culture."[30]

The SEZs are designed to encourage foreign investment and the import of both modern technology and the expertise of Western managers. The Chinese leadership hopes that the knowledge gained in the SEZs will be absorbed by the mainland and thus promote the whole country's economic growth.

The policies of the SEZs are as follows: Foreign investors receive approval of their projects from the customs offices of the zones, then contract with the Special Zone Development Corporation for the lease of land (which may last up to 25 years). Labor is hired by the enterprises instead of being assigned by the state labor department (which is generally the case outside the SEZs). Within guidelines set by the administrators of the SEZs, labor and management are free to enter into contracts concerning wage rates (payment by the piece, a combination of flat wage and floating wage, or a salary plus floating wage), labor insurance rates, and other payments. The enterprises also have the right to dismiss workers. Their products are primarily for export and are not subject to customs charges. And although there are no local taxes, the enterprises face a flat 15 percent state income tax.[31]

Shenzhen has been the most successful of the four SEZs; it had attracted about \$1.8 billion worth of foreign investments as of March 1978. In 1983 its industrial output was 11 times the 1978 figure, while domestic earnings had increased sixfold over 1980's and local foreign exchange earnings reached \$67 million. Labor income was 70 percent higher than in 1978.[32]

China is now fully aware that the SEZs are engines of capitalism, and its leaders do not seem to be ashamed. They realize that they are relying on entrepreneurial talent and market competition to develop their country, but they reconcile that course with their socialist ideology. "Whether a socialist country should make use of capitalism or not is a question that has long been resolved in theory and practice," one learns, for "Lenin creatively put forward the theoretical viewpoint of making use of capitalism to build socialism." [33] After all, to paraphrase a comment attributed to Lenin, the capitalists will sell the rope used for their own hanging. That is apparently the rationale of the Chinese leadership.

## Drawing the Line: Market and Plan

Outside of the SEZs, do the reforms in agriculture and industry allow us to conclude that China is moving down the capitalist road--toward the push and pull of the market process? To answer this, let us briefly examine the notions of market and plan.[34]

A complex society such as China essentially has two competing ways to coordinate the economic activities of its people: by means of a market economy and by means of a centrally planned economy. When resources are allocated and decisions coordinated through the market, an anarchic (undesigned) institution of voluntary exchange, each agent is free to pursue his own economic activities as long as he does not infringe upon the freedom of others to do the same. Goods are produced for the marketplace (Marx's "commodity production")--that is, for monetary profit, without edict or central direction. Questions such as what to produce, how to produce, and who will produce find their answers in the rivalrous interplay of market actors, each trying to outdo the others in the quest for profit. Those who have the insight and ability to judge the wants of the consumer better than others and to fulfill those wants by using resources--land, labor, and capital--in new and creative ways will enjoy a profit. Those who are not as alert and innovative will find the errors of their production decisions exposed in the form of losses on their balance sheets. In other words, the market works as a "discovery procedure," encouraging those who utilize resources efficiently and discouraging (or perhaps eliminating) those who cannot handle the responsibility. A true capitalist economy is a market economy in its purest form.[35]

Under the opposite system, all the economic activities in society are coordinated through a comprehensive, hierarchical plan. In a centrally planned economy, unlike a market economy, the responsibility for resource allocation and the coordination of economic decisions is placed in the hands of a few--the central planning board. The goals of the system's advocates are clear: to overthrow the rivalry of the market order and replace it with the authority of an organization that eliminates commodity production--that is, production for the marketplace and monetary profit--and institutes a single comprehensive plan to "scientifically" allocate resources and coordinate economic decisions. A true socialist economy is a planned economy without a market.

Where does China stand? That is, if we draw the line between capitalism and socialism in terms of market and plan, where should we place China?

China's economy is certainly not comprehensively planned. China's leaders have been making use of individual plans and guidelines and relying on market mechanisms to coordinate them. The introduction of the responsibility system, the expansion of private plot use, the move toward the profit and loss concept, and the adoption of market pricing in industry all attest to that. We learn from both popular Chinese literature and theoretical journals that China's "commodity economy does not conflict with a planned economy." [36] But that assertion is mere rhetoric. From an economic point of view, the two do conflict. The Chinese leadership is implementing pragmatic market reforms to encourage economic growth and development, yet it wants to remain socialist.

The problem is all too clear: markets are not consistent with Maoism. Their existence precludes the existence of socialist central planning. But China is not necessarily on the road to capitalism, for a number of reasons.

First, prices in China are still set according to the edicts of the central authority instead of spontaneously arising through a competitive market process. Thus, prices in China (with the exception of a few legally sanctioned markets and the underground economy) reflect not the degree of commodities' scarcity but rather the goals of the planners. Price reform is generally intended to encourage the production of certain commodities (such as fuel and raw materials) and discourage the production of others (such as wrist watches, cigarettes, and liquor). The question of how much to produce is still answered by the bureaucracy; state quotas continue to play a major role in both agriculture and industry. Although the state planners allow some prices to float after a quota is met, they determine the extent to which prices are allowed to float. By contrast, in a free-market economy, the prices of all goods float according to their relative scarcity, which can only be revealed through the competitive process. The same applies to wages.

Second, the surface of China's reforms suggests replacement of the Iron Rice Bowl, while the reality continues to be a strong "once hired, never fired" system. One does not have to read between the lines of the May 10, 1984, state council

decree or the decision of the October 20, 1984, Central Committee plenum to find the supposed freedoms of the wage and labor reforms subject to a host of guidelines and qualifications ("within certain limits," "with certain exceptions," "with approval of the authorities," "in line with state standards," and so on). Furthermore, the lack of labor mobility is essentially unchanged. Most labor is still allocated through administrative bureaus.

The price system has been "reformed," but it has not been freed. Indeed, China's leaders (quite legitimately) fear that if prices cease to be fixed by the state, the currently repressed inflation will mushroom into an open inflation. According to the Central Committee, "The reform of the price system and readjustment of various irrational price ratios carried out on our own initiative [that is, by state edict] will never bring about a general and spiralling price rise." But that policy simply encourages the status quo, thus virtually ensuring that pricing will remain largely irrational. As matters now stand, it is "absolutely impermissible for any unit or person to boost prices at will by taking advantage of the reform." [37]

China's irrational price system, in which prices are generally allowed to float only within the limits set by state edict, ineffectively coordinates supply and demand. [38] Shortages remain a large problem in the Chinese economy. Because prices generally fail to reflect the relative scarcity of goods and capital resources, they send misleading and highly ambiguous signals to consumers and producers, making it very difficult to assess the results of economic activity.

Third, China's leaders have allowed state-owned enterprises to operate for profit only in order to give managers an incentive to boost productivity and efficiency. In a true market economy, however, profit and loss serve as measures of economic success and failure. Those who profit have shown that they can organize resources in an efficient manner and therefore gain the confidence of investors, while those who suffer losses have shown that they are inefficient and therefore forfeit that confidence and their control of resources. Efficient producers have the ability to secure capital loans and perhaps enhance their position. On the other hand, inefficient producers, having exposed their mismanagement of resources, may face bankruptcy and find that few are willing to lend them capital. In short, enterprises in a capitalist system enjoy the financial rewards of their efficiency or suffer the financial consequences of their inefficiency.

It is difficult to find such a profit-and-loss system operating in China, for its state-owned enterprises operate under a "soft budget constraint," to use the term of the Hungarian economist Janos Kornai, rather than a "hard budget constraint." Although they may show profits and losses on their balance sheets, their survival depends more on political connections than on economic realities. About 20 to 30 percent of the enterprises have been running continuous yearly losses and surviving by securing loans and other subsidies from the state. [39]

Furthermore, the changes in the tax system leave the meaning of "profit" quite ambiguous. Most conspicuous is the so-called adjustment tax, the effect of which is to standardize the profits of firms within the same industry. [40] A capitalist system relies on profit as a measure of efficiency precisely because no one can predict the efficiency of a project. In a competitive race, crossing the finish line first is a measure of success. No one knows beforehand who the winner will be--the whole idea of the race is to discover who is the best. Taxing away the differences so that all cross the finish line at the same time and all are therefore winners (or losers) seems incongruous, yet that is what is being done in China's economic arena. Its administrators tax away "undeserved" profits (how do they know which profits are "undeserved"?) and subsidize enterprises that suffer losses. Thus, the enterprises' "profits" are not measuring efficiency. It is not clear what they are measuring.

However, China's economy is not a socialist economy in the sense of being truly centrally planned. Like all so-called planned economies, it is an extremely interfered-with market economy, for which strong state intervention, in the ideological guise of "planning," continues to create myriad unintended and undesirable consequences. [41]

### **Can China Modernize Its Politics?**

Modernizing China's economy means giving the existing market a greater chance to do its job. Yet because it is so far from being a true free-market economy, referring to the current economic reforms as a movement down the capitalist road would be stretching things a bit.

Developments during 1987 confirm a simple but important point: China can continue to modernize its economy only if



it modernizes its political system. Those who dare to predict China's economic future suggest that although the country will probably never return to its dim past (for the Chinese will wish to continue enjoying whatever benefits freer markets have so far provided), its reforms may nevertheless get stuck in a quagmire of regulations and corruption.

We can already see that taking place in agriculture, where local cadres function as both entrepreneurs and administrators. The problem is clear: they are entrepreneurs backed with coercive power. As Jean C. Oi put it, the "cadres have not so much lost power as refocused it." They have special access to opportunities and information, and they act as general contractors and overseers of commercial transactions. It is not uncommon for a new cadre to declare existing contracts invalid or take land away from some peasants and give it to others. They also have the power to arbitrarily levy fines on peasants. "What appears on the surface as a straight-forward, voluntary business arrangement is in fact open to cadre manipulation." Initially the local cadres were among those who resisted the reforms. But they have learned to use the reforms to further their own interests: "Once it became clear that the reforms were here to stay, the cadres quickly and easily moved into positions as the new middlemen in the system, ready and able to broker available opportunities and gain control over as many resources as possible." [42]

Corruption, overregulation, and general mistrust seem to permeate the entire party hierarchy. As Steven N. S. Cheung recently pointed out, "Regulations breed corruption, but officials who benefit from the practice are inclined to see that the regulations persist." Cheung recognizes the possibility that the system will become "mired in regulations"; he sees an "inevitable" slowing down in the pace of economic reform. [43]

Moreover, and most important, the Old Guard appears to be ascending. The forced resignation on January 16, 1987, of the party's leader, Hu Yaobang, sent a strong signal: the orthodox Marxists are trying to resist further change. Hu had suggested that the development of unorthodox ideas was necessary both inside and outside the party to further the progress of the reforms. Deng himself approved of the dismissal. As an April 1987 article in the Washington Post noted,

In the current struggle for political control, the conservatives have clearly gained in influence. While early reforms required courage and imagination, further changes may prove to be more difficult because they would significantly reduce the power and influence of bureaucrats and party members. Every move from now on will prove painful for someone. [44]

## **Conclusion**

China's decentralized economy does not seem to mesh well with its centralized political structure. Though the reforms have been rather limited, substantial economic progress has been made, and we can only imagine how much better off the typical Chinese citizen would be if there was a more substantial and systematic economic reform. Recently, however, the pendulum of reform slowed as pressures for a return to stronger party leadership began to be reasserted.

The question remains, How far will China go? It is not likely that the reforms will be reversed. China's citizens have prospered under the few markets that have developed. They will not readily give up the few economic freedoms they have gained. Last winter's student demonstrations in the name of democracy suggest that the citizens are prepared to fight for political reform as well. With greater economic freedom comes renewed hope for greater political freedom.

That correlation reflects a general principle of political economy perhaps articulated best by Milton Friedman:

Economic arrangements play a dual role in the promotion of a free society. On the one hand, freedom in economic arrangements is itself a component of freedom broadly understood, so economic freedom is an end in itself. In the second place, economic freedom is also an indispensable means toward the achievement of political freedom. [45]

But whereas the reflection is accurate, the substance is thin in China's case. Western observers have misjudged the extent of China's economic reforms; certainly President Reagan went much too far when he referred in 1984 to "so-called communist China." Though the economic reforms in China are welcome and there is more hope for today's Chinese citizen than there was for those of the past several decades, let us not confuse the potential for a more widespread, fundamental change with the reality of limited, piecemeal reforms.

China's leadership is feeling the sting of economic modernization. But it is just a sting. The benefits of further reform are presently outweighed by the costs in loss of party power and cohesion, so the party leadership must respond cautiously during the next few years or its overall legitimacy may fall into question. Should China fail to modernize its politics, one should not expect significant economic reform. But there is a glimmer of hope. At the opening session of the Communist party's 13th Congress in October, complaints about "major defects" in the party leadership were voiced. Resistance to further economic reform may have been overcome by Deng Xiaoping's symbolic gesture of stepping down from the party's Central Committee on November 1. Though Deng is expected to exert considerable influence on reform policy from behind the scenes, his move has already motivated other older leaders, most of whom are conservative opponents of his reforms, to step down as well. The events of the next several months should indicate the extent to which the party leadership can truly modernize China's politics and thus pave the way for systematic economic reform.[46]

## FOOTNOTES

[1] Quoted in Immanuel C. Y. Hsu, *China without Mao: The Search for a New Order* (New York: Oxford University Press, 1982), pp. 49-50.

[2] Quoted in "The Retreat from Marx," *Economist*, October 27, 1984, p. 18.

[3] *Ibid.*

[4] "The Fading in China," *Economist*, March 28, 1987.

[5] Quoted in Werner Klatt, ed., *The Chinese Model* (Hong Kong: University of Hong Kong Press, 1965), p. 4.

[6] The following table illustrates the extent to which the Great Leap Forward turned out to be a Horrible Leap Backward.

The table is taken from Gregory C. Chow, *The Chinese Economy* (New York: Harper and Row, 1985), p. 72. Chow notes that the official statistics for the years 1960 and 1961 are probably overestimates of the gross output value (and hence under estimates of the economic failure) due to political pressure on lower-level administrators to exaggerate the outputs of their units.

[7] Hsu, p. 95.

[8] "Rural Economic Reform: Questions and Answers," *China Reconstructs* 33, no. 4 (April 1985): 24.

[9] See Thomas B. Wiens, "Price Adjustment, the Responsibility System, and Agricultural Productivity," *AEA Papers and Proceedings* 73, no. 2 (May 1983).

[10] Edward A. Gargan, "China Considering Letting Farmers Sell Land Rights," *New York Times*, October 27, 1987, p. 1.

[11] See Steven N. S. Cheung, "China in Transition: Where Is She Heading Now?" *Contemporary Policy Studies* 4, no. 4 (October 1986). This article updates Cheung's earlier views, as expressed in *Will China Go Capitalist?* (London: Institute of Economic Affairs, 1982).

[12] See "Rural Economic Reform." Furthermore, "Decision of the Central Committee of the Communist Party of China on Reform of the Economic Structure, October 20, 1984" states that "the policy of encouraging some people to get better off earlier accords with the law of socialist development and is the only road to prosperity for the whole society." In John L. Scherer, ed., *China Facts & Figures Annual*, vol. 8 (Gulf Breeze, Fla.: Academic International Press, 1985), p. 145.

[13] Wiens, p. 323.

- [14] John L. Scherer, ed., *China Facts & Figures Annual*, vol. 9 (Gulf Breeze, Fla.: Academic International Press, 1986), p. 70.
- [15] Wiens, pp. 320-23.
- [16] *China Facts & Figures Annual*, vol. 8, p. 88.
- [17] *China Facts & Figures Annual*, vol. 9, pp. 95-96. Eliminating the grain quota and replacing it with more-market-oriented contractual agreements seems to have initially led to uncertainties and confusion that hampered grain production and distribution.
- [18] Ximen Lusha, "The Economy--Adjustment Brings Results," *China Reconstructs* 33, no. 2 (April 1984).
- [19] Jean C. Oi, "Commercializing China's Rural Cadres," *Problems of Communism* (September-October 1986): 3.
- [20] Hsu, p. 109.
- [21] *Ibid.*, p. 94.
- [22] S. H. Chou, "China's Industrialization," *Current History* (September 1981): 269.
- [23] William Byrd notes that these three elements of reform "involve drastic departures prevalent during the period of 'late-vintage Maoism' [1967-76]. Throughout that decade, material incentives at enterprise and individual levels in the state sector were strictly forbidden, the market played virtually no role in the allocation of producer goods and an extremely limited one in the allocation of consumer goods, and enterprise management had considerably less decision-making power." In William Byrd, "Enterprise-Level Reforms in Chinese State-Owned Industry," *AEA Papers and Proceedings* 73, no. 2 (May 1983): 329.
- [24] "Provisional Regulations on Greater Decisionmaking Powers for State Owned Industrial Enterprises," in *China Facts & Figures Annual*, vol. 8, PP. 87-88.
- [25] Over 80 percent of the state's income comes from taxes and profits levied on urban industrial enterprises. See "Decision of the Central Committee," p. 138.
- [26] The production of minerals and raw materials is also to be encouraged by a price reform, namely, raising the prices of traditionally undervalued commodities such as fuel and various raw and semifinished materials and lowering the prices of traditionally overvalued processed products.
- [27] See Christine Wong, "The Second Phase of Economic Reform in China," *Current History* (September 1985): 261.
- [28] "Decision of the Central Committee," p. 138.
- [29] Feng Gongwen, "Profit Is the Direct Aim of Socialist Enterprise Production," *Guangming Ribao* (Beijing), February 10, 1985, translated in *Foreign Broadcast Information Service* 1, no. 41 (March 1, 1985): k1-k6.
- [30] See Ji Chongwei, "Why China Has Opened Special Economic Zones," *China Reconstructs* 33, no. 9 (September 1984): 14-17.
- [31] Enterprises must, of course, abide by the laws of the People's Republic and the specific provisions of the special economic zones. But there are many laws that the investors have no knowledge of, and, worse yet, any attempt to discover them by consulting the party's internal documents is itself a violation of the law. Other legal problems also exist. For example, the mainland lacks a corporation or tort law. See Jan Prybyla, "China's Special Economic Zones," *ACES Bulletin* 26, no. 4 (Winter 1984): 4, 13-15.
- [32] Ji Chongwei, pp. 14-15.

- [33] Fang Sheng, "Are China's Special Economic Zones Practicing Capitalism?" *Renmin Ribao*, September 2, 1985, translated in *Foreign Broadcast Information Service* 1, no. 170 (September 3, 1985): k6-k9.
- [34] See Don Lavoie, *National Economic Planning: What Is Left?* (Cambridge, Mass.: Ballinger, 1985), chap. 2.
- [35] See F. A. Hayek, "Competition as a Discovery Procedure," in *New Studies in Philosophy. Politics. Economics and the History of Ideas* (Chicago: University of Chicago Press, 1979).
- [36] For instance, see Liu Mingfu, "On the Economic Reform of Socialist Economy," *Chinese Economic Studies* 13, no. 3 (Spring 1980); and Xue Muqiao, "An Inquiry into the Problems concerning the Reform of the Economic System," *Chinese Economic Studies* 17, no. 2 (Winter 1983-84).
- [37] "Decision of the Central Committee," p. 141.
- [38] For a more detailed study, see Dong Fureng, "China's Price Reform," *Cambridge Journal of Economics* 10 (1986): 291-300.
- [39] See *China Daily*, January 8, 1985, translated in *Foreign Broadcast Information Service* 1, no. 6 (January 9, 1985): k24- k26.
- [40] See Andrew G. Walder, "China Turns to Industry Reform," *Challenge* (March-April 1985).
- [41] This is true not only for China but for all of the so-called centrally planned economies, including the Soviet Union. See Paul Craig Roberts, *Alienation and the Soviet Economy* (Albuquerque: University of New Mexico Press, 1971).
- [42] For more on the cadre problem in agriculture, see Oi, from which these quotes were taken.
- [43] See Cheung, "China in Transition."
- [44] Daniel Southerland, "The Chinese Lesson: Political Barriers to Change," part three of a five-part series, "Communism: Can It Reform?" *Washington Post*, April 7, 1987, p. 12.
- [45] Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), p. 8. These ideas are also developed in F. A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944); and Ludwig von Mises, *Liberalism: A Socio-Economic Exposition* (Kansas City: Sheed Andrews and McMeel, 1976).
- [46] See Jim Abrams, "China's Deng Resigns Leadership Post," *Washington Post*, November 1, 1987, p. 37; and Edward A. Gargan, "More Change Due in China's Economy," *New York Times*, October 26, 1987, p. 1.