

## **The Evolution of Economic Reforms in China**

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### **1. Introduction**

This paper aims at analyzing empirically the evolutionary process of economic reforms in China. In Section II the problem of the big bang approach or the shock therapy approach versus the gradualism approach which took place in the transition from socialist economies to market economies in the former Soviet Union and East European countries is analyzed from the Chinese economic reforms' point of view. In Section III the Chinese economic reforms are reviewed from agricultural reform, enterprise reform, labor reform, fiscal reform, financial reform, and open-door policy. In Section IV problems of policy sequence are analyzed which appeared in the transition process of the former Soviet Union and Eastern Europe. The policy sequence problem is the one of sequence and speed. However, this problem is a new theoretical one in development economics and there are many issues to be discussed. In Section V China's policy sequencing is analyzed. In Section VI the national market formation problems in China are discussed. In Section VII the essential principles of the economy in the light of the Chinese economic history are discussed. In Section VIII I will conclude on the evolution of the economic reforms in China.

### **2. Big Bang versus Gradualism**

There is a theory called a "shock therapy" or a "big bang" approach which insists that economic reforms should be done all at once in the transition process of a socialist country into the market economy. This theory had influenced on the transition of the Soviet Union and East European Countries. Both the Five-Hundred Day Plan (FHDP) under the Gorbachev administration and economic reforms in Poland had of the big bang theory. A leading economist of the theory is Prof. J. Sachs of Harvard University. In his memoir, Mr. Gorbachev<sup>1</sup> told he was for the FHDP made by an old economist Shatalin and a young economist Yavlinsky at the early period of economic reforms. He

told after the FHDP became a severe political problem he agreed with a mixture of the FHDP with a gradual economic plan. Yakovlev<sup>2</sup> closest to the President said the government should have done agricultural reforms following agricultural reforms in China.

On the other hand, economic reforms in China began in 1978 and had a history of more than two decades. They are not only gradual reforms but also a product of the power struggle between the reformists and the conservative whereas the latter sometimes applied a brake on the economic reforms of the former. This mechanism of the power struggle brings about the gradualism where the economic reforms went zigzag. This fact is shown by my hypothesis that the agricultural sector has a policy cycle. The central economist of the conservatives is Chen Yun. Originally he belonged to the Zhou Enlai group, and died at 90 on April 10, 1995.

Furthermore, in the light of Prof. Oksenberg's analysis<sup>3</sup>, it takes a long time for the Chinese Communist Party(CCP) to make decision. In order to carry out an economic policy the Party chooses several pilot areas. After implementing the economic policy, the Party evaluates the results. And if the policy is good, then the Party spreads it all over the nation. This method of the CCP may reflect on the experience of base areas of doing economic policies during the guerrilla war under Mao Zedong.

These two different views arising from the transition process from a socialist to market economy have given a stimulus to Development Economics.

### **3. The Case of China's Economic Reforms**

#### **3.1 Agricultural reform**

Let's investigate the domestic economic reforms. In the light of agricultural economic reforms, in 1978 the Party introduced responsibility systems into the People's Communes, increased prices of agricultural products and decreased those of modern inputs. In 1983 the government allowed a peasant to employ seven workers. In 1984 it also allowed a peasant to sell agricultural produce beyond borders. In the end of the same year, the introduction of agricultural responsibility systems led to the decollectivization of the people's communes so that two household responsibility systems, i. e., the *'baogan daohu'* system and the *'baochan daohu'* system diffused. In the former system a farm household has responsibility for farm management under a contract with the township government. In the latter system a farm household has responsibility for production under a contract with the government. In terms of risk

sharing and incentives, the former is the same incentive system as the fixed rental system, and the latter the sharecropping system. Thus, the *'bao gan dao hu'* system has given peasants the strongest incentive for production.

With the second stage of agricultural reforms, the market mechanism was introduced in 1984. This led to the establishment of a double-track system.<sup>4</sup> The government replaced the government procurement system with a government contract purchasing system. Under this system peasants were allowed sell surplus grain on the free market once they had delivered their quota of grain to the government.

In 1986 the Land Administration Law was enacted. Under this law the government increased its buying at government guidance prices in order to give peasants greater incentive to increase production. The government guidance prices were higher than the contract purchasing prices but lower than free-market prices. A tax on the use of agricultural land was introduced in 1987. After the Tiananmen Incident in June 1989 and the strengthened position of the conservatives, the government directed the provincial governments to establish an agricultural development fund system. This was intended for developing agricultural infrastructure.

During 1990 the government oversaw the establishment of a wholesale grain market, a grain futures market, and a grain reserve system. The National Grain Reserve Bureau was set up as part of the grain reserve system. In 1992 the government opened the markets up while maintaining its own purchasing system. This meant that once the grain purchasing target was achieved, the government could engage in the operation of the market by adjusting the quantity of reserves as a buffer stock. However, government purchases were limited to products from major areas of production or those produced by large-scale farms.

The third stage of agricultural reforms commenced with the reform of the grain distribution system in 1993. The grain control system operates at the central and local government levels. Under this system the central government is responsible for national grain reserves and for the export and import of grain, while local governments are responsible for maintaining the balance of grain demand and supply and for overseeing the reserves within their jurisdictions. The government adopted a system of protective prices that were in effect guaranteed prices, and engaged in market operations to maintain grain price stability. This step can be seen as a move from a direct to an indirect control system of grain.

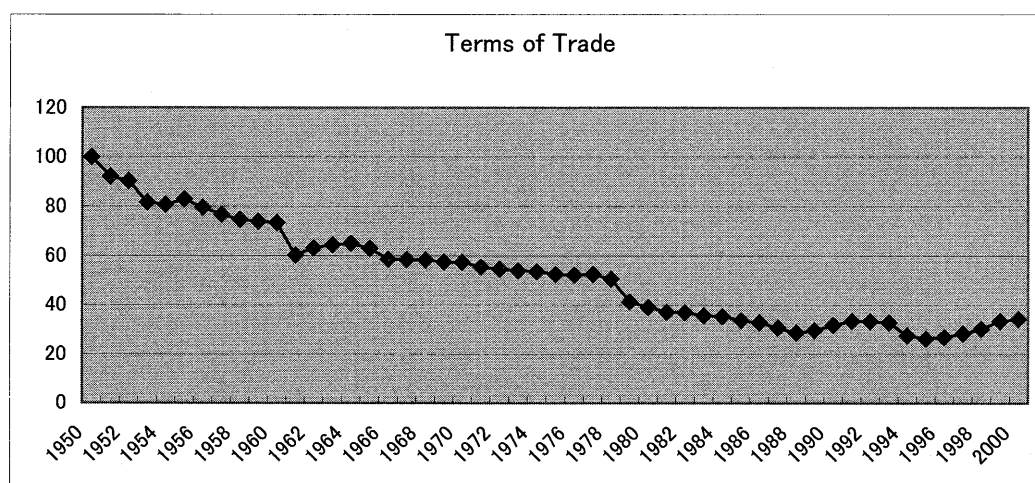
The Agricultural Law was enacted in July 1993. Following this, two systems were introduced in May 1994 to achieve a demand and supply balance in agricultural products. Under the first system, provincial governors were made responsible for grain

demand and supply. This system is called the governor responsibility system for the 'rice bag' (*midai zi shengzhang zeren zhi*). The second system placed municipal heads in charge of vegetables. This system is called the major responsibility system for the 'vegetable basket' (*cailanzi shizhang zeren zhi*). However, this attempt to achieve a balance through administrative means relied less on the price mechanism and more on the control of the quantity of foodgrains which seemed to run counter to the marketization of the economy.

In June 1998, the General Office of the CCP Central Committee and the General Office of the State Council announced the Grain Purchasing Regulations. These allowed only state-owned grain enterprises to purchase grain in rural areas and prohibited private merchants and private enterprises from doing so. However, grain processing enterprises and organizations in need of grain were allowed to purchase grain in markets operating at or above the county level. In October 1998, the government decided to liquidate the Beijing Commodity Exchange which was in an anarchic state and had failed to conduct market trading in a sound way. Subsequently, the eleven commodity exchanges across the country were integrated into three exchanges in Shanghai, Zhengzhou, and Dalian.

As a result, what effect did the agricultural price reform under the Deng Xiaoping regime have on the terms of trade between industry and agriculture? Figure 1 shows

Figure 1 Terms of Trade between the Industrial and Agricultural Sectors, 1950-2000



- Notes: 1. The terms of trade index is 100 .0 in 1950.  
 2. The terms of trade is the ratio of the rural retail price index of overall industrial products to the purchasing price index of general farm and sideline products.

the terms of trade index (TTI) between the industrial and agricultural sectors. The TTI decreased during 1978-88, increased during 1989-92, and again decreased during 1993-95. Then it again increased during 1996-2000, which means the deterioration of the agricultural sector. This fact shows the limits of the agricultural price reform. China will find it necessary to lower domestic prices of agricultural products higher than international prices. China joined the WTO on December 11, 2001 so that it will have to adopt structural adjustment policy rather than price policy.

The township and village enterprises(TVEs)<sup>5</sup> were established with the decollectivization of the people's communes in 1984. The Ministry of Agriculture issued the Provisionary Regulations on Peasants' Shareholding Cooperative Enterprises in February 1990, the Regulations on Rural Collective Enterprises in June of the same year, and the Provisionary Measures of the Development of Corporate Organizations of Township and Village Enterprise Groups and the Provisionary Regulations on Township and Village United Enterprises in January 1992, respectively. In order to develop the underdeveloped central and western regions, the government issued the "Decision on Accelerating the Development of Township and Village Enterprises in the Central and Western Regions" in February 1993, and approved the Plan on the East-West Cooperative Modeling Project of Township and Village Enterprises in order to let TVEs in the coastal and the central and the western region cooperate together.

In December 1996, the government issued the Township and Village Enterprise Law compiling all the regulations and measures on TVEs. This law defines TVEs as many kinds of enterprises in which peasants and rural collective economies mainly invested and which are obliged to support the agricultural sector. This law also clearly says that investment ratio of rural collective economies or peasants in a TVE must surpass 50% or that otherwise in reality they control shares or management.

Agricultural industrialization aiming at enlarging a scale of operation has begun in provinces such as Shandong and Zhejiang. The government made a list on agricultural industrialization in May 1996, and issued the Provisionary Regulations on the Approval and Direction of National Leading Enterprises for Agricultural Industrialization in July 2001.

In terms of agricultural administration, the Standing Committee of the NPC in December 1998 revised the Law on Organizing Village People's Committees(VPCs) enacted in November 1987, adding new regulations on the procedures of democratic elections and villagers meetings. The VPC is allowed to present, discuss, and decide (1) the collection, payment, and use of unified costs of the township government and retained costs of the village, (2) the number of members of the VPC to receive travel

expenses and the amount of travel expenses, (3) the use of profits form collective economies of the village, (4) making a plan of collecting money for public works such as the construction of schools and roads, (5) a plan of establishing village-owned enterprises and of making a contractor manage them, and a plan of contracted construction of public works of the village, (6) villagers' management responsibility system, and (7) a plan of the use of land.

### **3.2 Enterprise reform**

Enterprise reform in China began with expanded autonomy in 1979. The government issued five regulations for expanded autonomy: (1) the Regulations on Expanded Enterprise Autonomy, (2) the Regulations on Profit Retention of State-Owned Enterprises(SOEs), (3) the Regulations on the Collection of Fixed Assets Tax, (4) the Regulations on the Improvement of the Depreciation Ratio of Fixed Assets of State-Owned Industrial Enterprises(SOIEs) and the Using method, and (5) the Regulations on Lending of Working Capital. Among these regulations, the most important is the second regulations admitting to use the retained profit as the production development fund, the welfare fund and the bonus fund for staff and workers.

In 1980, the new Regulations on Profit Retention enacted whereas two profit retaining systems, i. e., that of retaining a certain ratio of profit in the previous year as a base and that of retaining a high ratio of profit in the current year. In August 1980, the State Economic Commission expressed the "Report on the Situation of the Experiment of the Expanded Autonomy of State-Owned Enterprises and Opinions about the Future." It decided to expand the autonomy from the pilot 6600 units to SOEs in the whole nation. However, the Central Work Conference in the end of 1980 decided to strengthen economic adjustment, freezing the expanded autonomy of SOEs. At the beginning of 1980, Sichuan province began the experiment of self-supporting and state taxing systems in five SOEs.

In 1980, this system diffused into 191 SOEs in Shanghai, Beijing, and Guangdong province but the adjustment policy of strengthening depressed this diffusion. In 1981, economic responsibility systems following the agricultural responsibility systems were introduced into the SOE sector.

The major contents are as follows: (1) the SOEs' responsibility for the state, and (2) the responsibility system within the enterprise. In the former system, the SOE is responsible for the fulfillment of planned targets and for giving profit to the state. And a certain share or the whole of the above-quota goes to the SOE. In the latter system, each

unit of a factory such as a group, team, and worker are responsible for the fulfillment of work. Wages of workers are related to their fulfillment. In the end of August 1981, 35 thousand SOIEs sharing 65% of all the SOIEs introduced this system.

In November 1981, the government approved and circulated the "Several Opinions of the State Economic Commission and Economic Restructuring Office under the State Council on Carrying Out the Industrial Economic Responsibility System(IERS)."

In December of the same year, the government issued the Provisionary Regulations on Several Problems in Carrying Out the Industrial Economic Responsibility System. The regulations define the IERS as the management system aiming at combining responsibility, right, and profit for the improvement of economic efficiency. The regulations say contracting items should include not only the profit presented to the state but also production output, quality, cost and so on. And Shoudu Iron & Steel Enterprise became the model of the IERS. In the end of 1981, the government issued the "Opinion on Strengthening Direction, and Grasping Retrenchment Works of SOEs Well," and expressed it would retrench leader groups of SOEs in two to three years. In April 1983, the government issued the Provisionary Regulations on State-Owned Industrial Enterprises. The regulations say that SOEs should carry out the factory manager responsibility system(FMRS) and the meeting of representatives of staff and workers.

At the Fifth NPC in November 1982, Premier Zhao Ziyang made it clear to carry out the reform of 'tax for profit'(*li guai shu*). In March 1981, the Ministry of Finance(MOF) issued the Several Regulations on the State-Owned Enterprise's Carrying Out the Reform of 'Tax for Profit'. At the same time, the MOF held the National Work Conference on the Reform of 'Tax for Profit', and in April the government issued formally the Provisional Measures of the State-Owned Enterprise's Carrying Out the Reform of 'Tax for Profit'. In fact, this reform began in 1985.

On January 1, 1983, the 'tax for profit' system was introduced, and the procedures began on July 1, 1983. In this reform, the government levied a corporate tax rate of 55% on the large and medium-sized SOEs while still adopted the profit payment system. The objective of this reform was to adjust the phenomena of the '*bian da quai niu*'(whipping the fast cow) where the highly productive SOEs at the time of the introduction of the profit retention system had only a low retention ratio because of the low growth of profit and vice versa.

Furthermore, this reform aimed at rebuilding the public finance of the central government weakened by the fiscal reform dividing clearly revenues and expenditures between the central and local governments and also at having the SOE sector

independent from the state.

In his "Report of Work of Government"<sup>6</sup> at the Second Session of the Sixth NPC in May 1984, Premier Zhao Ziyang stated:

The government has decided to keep the reform of 'tax for profit' at the second stage going and to make the transition from the co-existence of profit payment and taxation to the corporate income tax system gradually.

Major contents of the reform at the second stage are as follows:

- (1) to decompose industrial and commercial tax into product tax, value-added tax(VAT), salt tax, and operation tax applied for each industry. Rates of product tax and VAT should be higher for high profit products while lower for low profit products such as coal.
- (2) to levy resources tax on mining enterprises. For the time being, crude oil, natural gas, and coal should be taxed. The government should carry out tax exemption for small coal mining.
- (3) to set new taxes on town maintenance and construction(TTMC), on real estates, on the use of urban land, and on the use of vehicles and ships. The TTMC would be levied from January 1985.
- (4) to levy corporate income tax on SOEs producing surplus. The tax rate for the large SOE's profit after taxes in (1), (2), and (3) would be 55% and that for the small-scale SOE's profit the eight-class progressive rate.
- (5) to levy adjustment tax on the rest of profit after corporate income tax so far as it was over the rational level of retained profit. The government determines adjustment tax for each firm according to the profit in 1983 as a base. The government cuts 70% of the increase in profit(60% at the second stage). The tax rate should be unchanged for seven years.
- (6) to adopt the same policy at the first stage for SOEs having loss and less profit or for those contracting to increase profit.
- (7) to make the reform of industrial and commercial tax the complete one for the tax system. Many regulations except the measures of collecting adjustment tax should be applied for the collective and private enterprises.

The above regulations are enacted on October 1, 1984.

In May 1984, the "Ten Articles on Expanded Autonomy of SOEs" was issued. SOEs were allowed to sell the above-quota output in the free market after the fulfillment of the quota to the state.

The major contents are as follows:

- (1) The SOE should be allowed to produce output which the state and market want



- given the fulfillment of the quota under the national plan;
- (2) The SOE should be allowed to sell freely products except ones forbidden by the state;
  - (3) The SOE could set prices of capital goods sold to the free market with a price band with a margin 20% above and below a reference price;
  - (4) The SOE should have a privilege to select sellers in buying capital goods within the quota system;
  - (5) The SOE should be allowed to retain 70% of depreciation funds, and to invest production development funds not used for the time being outside it;
  - (6) The SOE should be allowed to lease out fixed assets unused or to transfer them with appropriate fees. The revenues from the transfer of fixed assets should be used for technological improvement and the renewal of equipment;
  - (7) The SOE should be allowed to decide how to make organizations and how to allocate staff and workers voluntarily. Its related upper organizations are not allowed to order the SOE to do what they want about these problems;
  - (8) The upper organizations should be allowed to appoint a factory manager and secretary for the Party Committee and to enable a factory manager to nominate a deputy manager and deputy secretary whom the upper organizations approve. A factory manager is allowed to appoint middle-class cadres;
  - (9) The SOE should be allowed to select the wage system fit to it given that it carries out national wage standards and wage systems by region and industry, giving unified subsidies in the whole nation; and
  - (10) The SOE should be allowed to join many kinds of united management across departments and districts given unchanged forms of ownership and subordinating relations to the upper organizations.

In July 1984, the government issued the Provisionary Regulations on Tax on Bonuses of SOEs, abolishing the upper and lower limits of bonuses, giving them payment autonomy and having tax on adjusting wages.

In May 1984, the Party Center and the State Council issued the "Notice on Carrying Out Pilot Works of Reforming the Directing System on State-Owned Industrial Enterprises" ordering the experiment of changing the factory manager responsibility system under the Party Committee into a simple one. This reform began in Beijing, Tianjin, Shanghai, Shenyang, Changzhou, and Dalian.

A new problem of the separation of firms from administration (*zhengqi fenkai*) occurred in 1984. In August 1984, the government approved and issued the "Report of the Ministry of Machinery Industry (MMI) on the Reform of the Management System of Machinery Industry." In the MMI reform, enterprises were affiliated to major cities and

pay taxes to them. Departments of machine industry in these cities did not control enterprises, and had responsibility for factory managers and accounting. The MMI did not control enterprises but carried out management by industry and skill. That meant the decision making of direction and policy, study and enactment of laws, decision of medium- and long-term economic plans, and an annual plan. In September 1986, in order to carry out the factory manager responsibility system the Party Center and the State Council issued three regulations, i. e., the Regulations on Factory Managers of State-Owned Industrial Enterprises, the Regulations on Works of Basic Organizations of the Chinese Communist Party in State-Owned Industrial Enterprises, and the Regulations on the Meeting of Representatives of Staff and Workers of State-Owned Industrial Enterprises. In 1986 the Bankruptcy Law on State-Owned Enterprises and the Regulations on the Quality of Industrial Products were enacted. In terms of labor system, contract systems were introduced.

In 1987, the management contract system was introduced. In July 1988, the State-Run Enterprise Law was enacted. In July 1988, the Regulations on Admitting the Lease of Small-Scale State-Run Enterprises were also enacted. On the other hand, the Provisionary Regulations on Private Enterprises, the Provisionary Regulations on Corporate Tax on Private Enterprises (PEs), and the Regulations on Collecting Adjustment Tax on Individual Revenues Invested in Private Enterprises were issued. Thus, the Status of PEs was established legally for the first time.

In May 1992, the State Economic Restructuring Commission (SERC) and the State Planning Commission issued the Measures of Pilot Joint-Stock Companies, and the SERC issued the "Opinion on Joint-Stock Companies," and the "Opinion on Limited Companies." Here joint-stock companies were admitted officially.

In July of the same year, the Regulations on the Conversion of Management Mechanism was issued. Under the promotion of shareholding system the '*guoying qiye*' (state-run enterprise) became the '*guoyou qiye*' (SOE). Here for simplification I use the term SOE before and after issuing the regulations.

In November 1993, the "Decision of the Chinese Communist Party Center on Several Problems of Establishing the System of Socialist Market Economy"<sup>7</sup> (the "Decision") emphasized the establishment of a modern corporate system so that the government carried out the separation of firms from administration. The "Decision" says that ownership of property of the SOE should revert to the state and that the maintenance and increase of asset values should belong to the SOE. Companies are classified into a limited company and a joint-stock company, and the former is only limited to a state investment company. Along with the strengthening of insider control

rising from the collapse of the profit payment system, the experiment of controlling state-owned assets in the form of a holding company was carried out in both Shanghai and Shenzhen.

In terms of evaluation of state-owned assets, the government issued the Law on the Control of Evaluation of State-Owned Assets in November 1991 and the Regulations on Controlling the Supervision of Assets of State-Owned Enterprises in July 1994, and the Law on the Registration of Ownership of State-Owned Assets of Enterprises in January 1996, respectively. The MOF and the Entry and Exit Bureau issued the Measures of Controlling the Evaluation of Assets of Foreign Firms in March 1994.

Zhu Rongji who became the Prime Minister in March 1998 made it clear that the government would finish the reform of SOEs in three years. The problem of bad loans in China is still an important problem so that he proposes to establish the same organization of dealing with credits as Japan's. In dealing with the bankruptcy of Guangdong International Trust and Investment Corporation, the government stated it gave foreign banks the same status as domestic creditors in compensating creditors for their loans. This statement caused a lot of international criticism. The government stressed that it would deal with other international trust and investment corporations in the form of merger rather than bankruptcy.

In the administrative reform during the 1993-95 period, the State Economic and Trade Office Vice-premier Zhu Rongji had established became the State Economic and Trade Commission. This commission was established following the Ministry of International Trade and Industry in Japan. It was not until the "Guideline on Industrial Policy in the 1990s"<sup>8</sup> that the government dealt with industrial policy in China. The government issued the "Industrial Policy on Automobile Industry" in August 1994.

Furthermore, the government issued the Unlimited Partnership Law in February 1997. In September 1999, the Fourth Plenum of the 15th Central Committee of the CCP passed the "Decisions on Several Problems on the Reform and Development of the State-Owned Enterprises"<sup>9</sup> where the Party stressed the government should give large SOEs, enterprise groups, and holding companies the right to manage state-owned assets.

### **3.3 Labor reform**

In terms of employment, in 1978 a retired age system was introduced where the male retired age was 60 years old and the female one 55 years old. In November 1981, the "Several Decisions on Developing a Broad Way, Revitalizing the Economy, Solving

Urban Employment Problems” was issued. Then, contract workers as well as temporary workers were approved. In July 1986, the Party Center and the government issued the Regulations on Labor Contracts of State-Owned Enterprises. The government decided that newcomers would become contract workers. So far the ‘*dingti zhi*’ where a retired worker was replaced by his(her) son or daughter was taking place. The system was abolished by the introduction of the contract system. At the same time, three regulations, i. e., the Provisionary Regulations on the State-Owned Enterprise’s Employing Workers, the Provisionary Regulations on the Insurance of the Unemployed Staff and Workers of State-Owned Enterprises, and the Provisionary Regulations on the Resignation of the Staff and Workers Offending the Laws were issued. In April 1992, the Labor Union Law was enacted. The Regulations on the Conversion of Management Mechanism of State-Owned Enterprises in July 1992 stated that a firm should have the right to fire workers. In April 1993, the government issued the Regulations on Reallocation of Surplus Staff and Workers of State-Owned Enterprises defined the measures of layoffs (*xiagang*), the procedures of firing, the amount of retired money etc. In addition, the government issued the Regulations on Unemployment Insurance in April 1993, and the Regulations on Dealing with Labor Disputes in Firms in July of the same year. Here, the labor dispute not settled would go to the mediation committee. The labor dispute not mediated would go to the arbitration committee. The labor dispute not arbitrated would go to a court(*renmin fayuan*). And the Arbitration Law was enacted in April 1994. The Ministry of Labor issued the Regulations on the Management of the Old-Age Insurance Fund for Staff and Workers of Firms in July 1993.

In July 1994, the government enacted the Labor Law defining promotion of employment, individual and collective contracts, working hours and holidays, wages, labor safety and health, protection of female staff and workers and those under age, job-training, social insurance and welfare, labor disputes, direction and inspection, legal responsibility etc.

In terms of wages, the “Decision” in the Third Plenum of the 12th Central Committee of the CCP in November 1993 states in its Article VII the simultaneous reform of promotion of the wage and labor systems.

In October 1984, the government approved and issued the State Planning Commission’s the Provisionary Regulations on the Improvement of Economic Planning System. The major contents of this document are as follows:

- (1) The state should show planned targets of staff and workers of SOEs and total amounts of wages;
- (2) Apart from small-scale SOEs with the self-supporting accounting system including

lease and contract systems, total amounts of wages should be increased or decreased according to the level of the fulfillment of planned targets and economic effects based on the proportion determined by the state;

- (3) The growth rate of average wages of staff and workers should not exceed that of labor productivity; and
- (4) The state should control the total amount of wages by collecting bonus tax and other taxes. This was called the “dual-distribution system” where the state determined the total amount of wages and firms the wages within the total amount of wages. This wage determination system has changed along with the development of the marketization of the economy.

The “Decision” in November 1993 states that administrative organizations of enterprises and project units should establish following wage systems and wage increase ones fit to them.

- (1) SOEs should make the growth rate of total wages less than that of economic efficiency, making the growth rate of average wages less than that of labor productivity. Given these conditions, SOEs should determine the wage levels and the distribution system within them independently;
- (2) Administrative organizations should carry out public service system, and determine and adjust their wage level according to the degree of economic development and firm’s average wage level, establishing the normal wage and the wage increase system;
- (3) Project units should carry out the wage and the distribution system different from administrative organizations’. However, they may carry out the SOEs’ wage system and wage increase one; and
- (4) The state should establish the minimum wage standard while many kinds of SOEs and project units must strictly carry out the wage standards. The state should promote monetization and normalization of individual revenues.

The Ministry of Labor issued the Regulations on the Minimum Wage of State-Owned Enterprises in November 1993 and the Regulations on Wage Control of Joint-Stock Companies and the Provisionary Regulations on Providing Wages in December 1994, respectively.

### 3.4 Fiscal reform<sup>10</sup>

Fiscal reform began with the conversion of the system of ‘*tongshou tongzhi*’ (the unified revenues and the expenditures) to that of the ‘*huafen shouzhi, fenji bao gan*’ (classifying revenues and expenditures clearly and making contract of collecting

taxes with local governments at each level) in 1980. The former means that the central government controlled total revenues and expenditures. The latter means that the central government determines the revenue and expenditure of a local government, deciding the payment ratio for the central government based on the 1979 revenue or making a contract for the revenue with the local government under a fixed subsidy for five years. In 1983, the system of the '*zong'e fencheng, bili baogan*' began where the central government distributed total budget to each local government which made a contract for paying the fixed ratio of revenues with the central government.

In 1985, following the reform of the '*li guai shui*' (tax for profit), the government adopted the system of the '*heding shouzhi, fenji baogan*' where the central government divided all the taxes into three categories, i. e., taxes for the central government, those for the local governments, determining revenues and expenditures of each local government and making contract for paying revenues with each local government. In 1988, the central government established the system of the '*shouru dizheng baogan*' where it made a contract for increasing revenues with each local government. Especially, fiscal reforms after 1985 brought about a decrease in the revenue of the central government, that is, the ratio of the central to local government revenues became four to six. In this sense, if inflation occurs, the central government cannot use compensatory fiscal policy to control inflation. Thus, in 1993, the central government introduced tax assignment system (*fenshui zhi*). In December 1993, in order to make a comprehensive circulation tax system the government enacted the Provisionary Regulations on Value-Added Tax, the Provisionary Regulations on Consumption Tax, and the Provisionary Regulations on Sales Tax, respectively. The government issued the Regulations on National Bonds in March 1992, and enacted the Budget Law in March 1994, respectively. The Budget Law was carried out in January 1995. The government also issued the Audit Law in August 1994.

In terms of agricultural budget, the MOF issued the Provisionary Measures of Controlling Budgets in Townships and Villages. In July 1986, the government issued the Regulations on the Management of the Special Fund for Foodgrains Production. This fund comes from tax revenues from the TVEs. The MOF issued the Several Regulations on Saving of Expenditures of Projects in May 1987, the Measures on the Management of the Agricultural Development Fund in August 1989, and the Several Regulations on the Financial Management of Project Units in January of the same year, respectively.

In December 1991, the government issued the Regulations on Peasants' Costs and Labor Management defining peasants' payments and labor. However, peasants' fiscal

burden problems are still unsettled.

#### **E. Financial reform**

Financial reforms began with the issue of the Provisionary Regulations on Banking Management and the appointment of five cities such as Guangzhou, Chongqing, Wuhan, Shanghai, and Changzhou as financial experiment cities in January 1986. The Shanghai Stock Exchange was established in December 1990, and the Shenzhen Stock Exchange in July 1991, respectively.

The government issued the Regulations on Accountants in December 1990, and the Lawyer Law in May 1996, respectively. The government issued the Provisionary Regulations on Cash Management in order to cover settlements in cash between firms in September 1988, and the Regulations on Saving in December 1992, respectively.

In June 1983, the government issued the Regulations on the Control of Gold and Silver in order to strengthen the control of gold and silver and stop speculation. Thus, only the People's Bank is allowed to buy gold and silver. In November 1992, the MOF issued both the Regulations on Corporate Finance and the Regulations on Corporate Accounting. In April 1993, the government issued the Regulations on the Issues and Trading of Shares while the China Securities Regulatory Commission under the State Council the Provisionary Measures of the Management of the Stock Exchanges in July 1993, and modified the measures, issuing the Measures of the Management of the Stock Exchanges. The State Economic Restructuring Commission issued the Regulations on Giving Directions to Raising Shares Held by Staff and Workers in Joint-Stock Companies in July 1993. The government issued the Regulations on the Management of Corporate Bonds in August 1993, abolishing the Provisionary Regulations. Furthermore, the Auction Law was enacted in July 1983.

The People's Bank of China became the central bank in 1983 so that the business department was independent and became the Industrial and Commercial Bank of China. In December 1993, the government issued the "Decision on the Reform of Financial System"<sup>11</sup> and decided to establish three policy-oriented banks, namely the State Development Bank of China, the Import and Export Bank of China, and the Agricultural Development Bank of China. The Third Session of the Eighth NPC in March 1995 passed the Central Bank Law while the 11th Session of the Standing Committee of the same NPC passed the Commercial Bank Law. Based on this law, four special banks were to be commercial ones.

In terms of laws related to financial business, the government issued the Bill Law in May 1995, and the Mortgage Law and the Insurance Law in June of the same year,

respectively. The Ministry of Internal Trade issued the Several Regulations on Strengthening the Control of Credit Cards in November 1994. The government issued the Securities Law in December 1998. The formation of call market started in 1981 but it was not until January 1996 that the national call market formally began to work.

In August 1996, the government issued the "Decision on the Reform of Rural Financial System"<sup>10</sup> stressing (1) strengthening the united rural credit cooperative(RCC) at the county level, (2) strengthening the People's Bank's control of the RCCs, (3) not making the Agricultural Bank control the RCCs, (4) not establishing controlling organizations beyond the county level, and (5) letting the RCCs in the areas integrating urban and rural areas form the Agricultural Cooperative Banks.

China will have to carry out liberalization of interest rates in five years after the entry to the WTO.

### **3.5 Open-door policy**

Open-door policy in China began with the inflows of foreign capital by the enactment of the Law on Chinese-Foreign Joint Ventures in July 1979. In August 1980, the "Regulations on Special Economic Zones in Guangdong Province" was approved and four Special Economic Zones(SEZs) such as Shenchen, Zhuhai, Shantou, and Xiamen were placed. In April 1984, 14 coastal cities, including Shanghai, Tianjin, and Guangzhou were opened. In May of the same year, Hainandao became a quasi-SEZ. In February 1985, three coastal development areas, i. e., the Changjiang Delta, the Minnan Triangle Area, and the Zhuhai Delta were approved. In the end of 1987, Guangdong and Fujian provinces were opened fully. In April 1988, the First Session of the Seventh NPC decided to set up Hainan SEZ.

General Secretary Zhao Ziyang expressed the following idea of coastal area development strategy<sup>12</sup>:

- (1) Its first stage( five to seven years): to promote exporting of labor-intensive products in the coastal areas and to construct bases for exporting domestic products in inner areas.
- (2) Its second stage (five to seven years): to export products in inner areas and to develop capital-intensive industry at the same time.
- (3) Its third stage: to develop heavy industry mainly. With the development of capital- and technology-intensive industry, the exporting ratio of labor-intensive products will begin to decline. This stage would be in the second half of the Ninth Five-Year Plan (1996-2000).

This development strategy is based on that of Asian newly industrializing



economies (Asian NIEs). In 1996 the debate on the policy of utilizing foreign capital occurred and the case for the protection of national industry and the case for the abolishment of the Seas appeared. However, the SEZ Work Conference in Shenzhen in January 1997 concluded that the existing policy of utilizing foreign capital should be maintained.

In December 1981, the Economic Contract Law was enacted and modified in September 1993. In addition, the Overseas Economic Contract Law was enacted in March 1985, and the Technology Contract Law in June 1987.

The Law on Foreign Capital Enterprises was enacted in April 1986 and the Law on Chinese-Foreign Equity Joint Ventures in April 1988. In July 1990, the government issued the Regulations on Encouraging Investment of Hong Kong and Macao having no limit of the contract duration of joint ventures. The government issued the Measures of Land Development Management of Foreign Firms in May 1990. In April 1991, the government issued the Corporate Income Tax Law on Firms Related to Foreign Direct Investment and Foreign Firms, abolishing the Corporate Income Tax Law on Joint Ventures and that on Foreign Firms.

In December 1993, The Standing Committee of the NPC issued the "Decision on Provisionary Regulations on Collecting Value-Added Tax, Consumption Tax, Sales Tax and So On". In October 1993, the government issued the Regulations on Cooperative Development of Oil Resources on Land with Foreign Firms.

In September 1987, the People's Bank of China issued the Regulations on the Issues of Bonds by Domestic Organizations. In August 1994, the government issued the Special Regulations on Domestic and Overseas Issue, Subscription, and Listing of Stocks of Joint-Stock Company. The Regulations on Domestic Listing of Stocks of Foreign Joint-Stock Companies issued in August 1995 set an upper limit of face-value of 30 million dollars.

In terms of monetary policy, the government issued the Preliminary Regulations on the Management of Foreign Exchange. In January 1981, the government adopted a dual exchange rate system. The market for adjusting demand and supply for foreign currencies was set up one after another in Shenzhen, the other SEZs, and major cities such as Shanghai.

Based on the revised regulations in March 1988, banks could sell and buy foreign currencies not through the Bank of China. And there were double exchange rates, i. e., the domestic settlement rate and the official rate. In January 1994, the government devalued the yuan to 8.7 yuan per dollar, adopting a single exchange rate. In January 1996, the government issued the Regulations on the Management of Foreign Exchange,

abolishing the Provisionary Regulations.

In January 1993, the State Foreign Exchange Administration issued the Regulations on the Management of Foreign Exchange Business of Non-Banks. In July 1994, the government issued the Measures of the Management of Inflows and Outflows of Foreign Currencies regulating the amount of inflow and outflow of foreign currencies. In March 1994, the government issued the Regulations on the Management of Foreign Financial Organizations, and the People's Bank of China the Provisionary Regulations on Foreign Exchange Settlement, Selling and Payment. Thus, China became the Article VIII member country in the IMF.

In November 1986, China approved the U. N. International Cargo Trade Treaty. In January 1987, China issued the Tariff Law and cut the tariff rates of many items in order to join the GATT. In April 1988, the General Administration of Customs approved bonded areas. Import quota system was introduced in December 1993 while tax rebate system in February 1994. The government approved the Regulations on Country of Origin of Exports in March 1992. The Maritime Affairs Law was enacted in November 1992, and the Foreign Trade Law in May 1994 respectively.

The United States had given China the most favored nation(MFN) status since 1974. After the Tiananmen Incident, there was a big debate on whether the United States would stop giving China the MFN status or not. After all, the U. S. government made it a rule to renew it for China every year.

In January 1999 Xiang Huaicheng, Minister of Finance, expressed that the abolishment of according privileges to the Economic Technological Development Areas. The government made it clear to cut the VAT rebate ratio of consumption to firms step by step to zero. This decision was said to be a condition to join the WTO demanding equal treatment between domestic and foreign firms. But tax cut and exemption policies in the SEZs were unchanged. The government decided to give the SOEs the right to export and import.

On July 1, 1997, Hong Kong's sovereignty was returned to China by the United Kingdom. Hong Kong became a Special Administrative Region of China, but capitalism in Hong Kong is guaranteed to exist for 50 years. Under the Hong Kong Basic Law approved by the Third Session of the Seventh NPC, China's tax policy is not applied for Hong Kong. Hong Kong's investment in China is treated as the foreign direct investment and its trade with China as foreign trade. In the beginning of 1998, Hong Kong made anti-double taxation treaty with China. Macao was also returned to China on December 10, 1999.

Economic crisis that occurred in Thailand in 1997 brought Asian countries into

depression. China stressed that it would not devalue the yuan with foreign exchange earnings of 140 billion dollars. And so far Beijing did not devalue the yuan while stressed that to protect Hong Kong dollar was not their task but Hong Kong's.

#### **4. Problems of Policy Sequence**

An important problem coming out in the course of studying a problem of big bang versus gradualism is a policy sequence problem of how to carry out economic policies in order. Here policy sequencing is regarded as a policy package. Correctly speaking, it is a matter of sequence and speed.<sup>13</sup> Prof. S. Fisher( Ex-Deputy Executive Director of IMF) and Prof. L. Summers(Ex-Secretary of Finance of the U. S. Government) proposed the following solution(See Figure 2).<sup>14</sup> Their scenario is as follows:

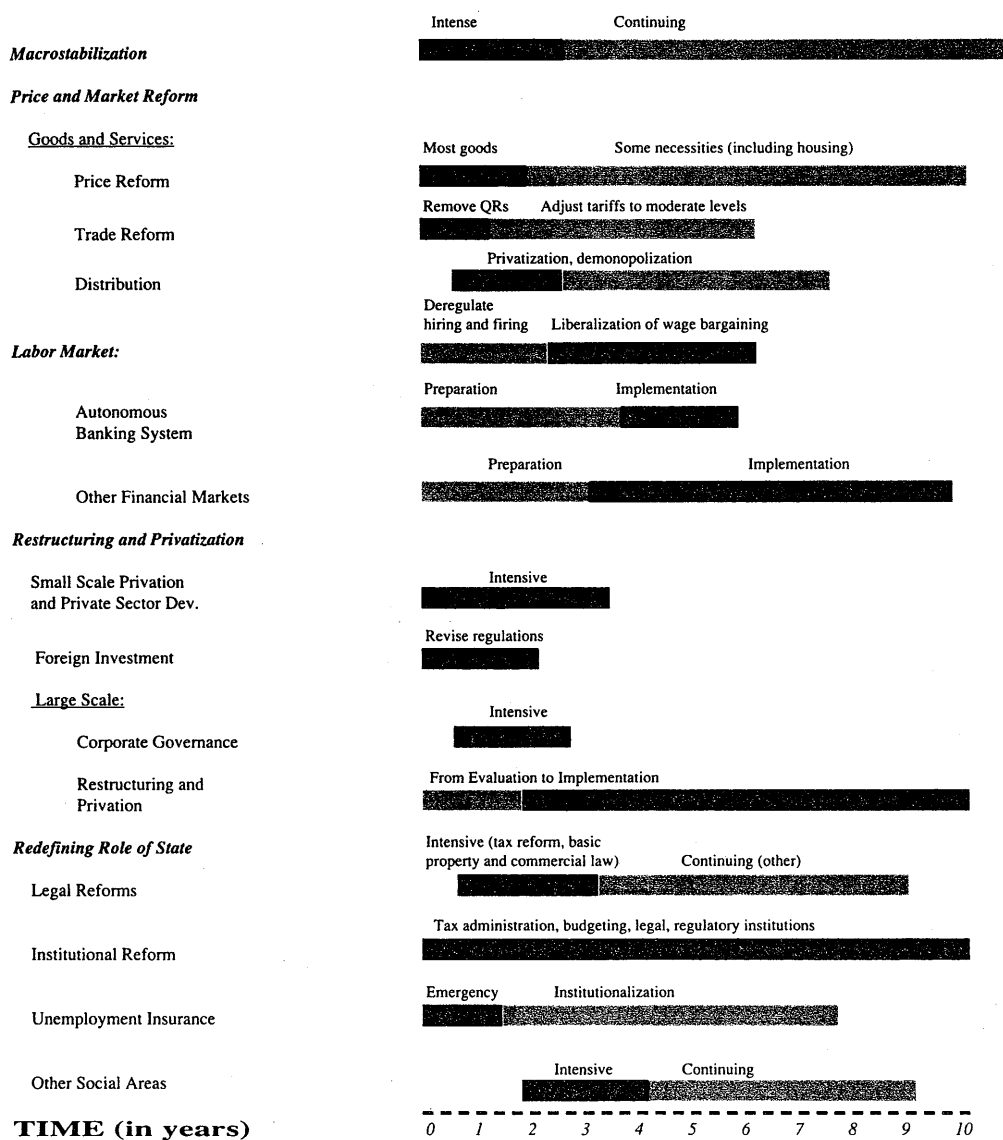
- (1) Stabilization of macroeconomy should be done. After that, price and trade reforms follow. Price reform should be carried out before liberalization of capital market. Because the adjustment speed in the goods market is much slower than in the assets market. Trade reform means liberalization of current account;
- (2) Tax reform, social security policy, and measures of supporting private firms should be done;
- (3) Enterprise reform, privatization, institutional reforms, and legal reform should be carried out in the first stage of economic reform. However, it takes a long time to finish these reforms; and
- (4) Liberalization of monetary market should be done in the first. Then liberalization of capital account and that of wage determination should follow monetary reform.

#### **5. China's Policy Sequence**

China has quite different initial conditions from the former Soviet Union and Eastern Europe. China has a dual economy which Prof. W. A. Lewis<sup>15</sup> appointed, so that it is very natural that China has carried out agricultural reform before industrial reform. China has limited rapid migration of labor from agricultural to industrial sector. This point is quite different from the flame work of policy sequence. And social securities policy in China lags behind so much that labor market is imperfect.

In 1985, a double-track system was introduced under conditions of macroeconomic stabilization prerequisite for price reform. In 1988 General Secretary Zhao Ziyang tried

Figure 2 Phasing of Reform



Source: Summers, L., "The Next Decade in Central and Eastern Europe", in Clague, C., and G. C. Rauser eds., *The Emergence of Market Economies in Eastern Europe*, Cambridge: Basil Blackwell, 1992, p.33, Fig.1.

to make price reform go further as he underestimated inflation. In this context he made a serious mistake. At the Party Conference at Beidahe in August 1988 he proposed a new price reform at the second stage. As soon as the *People's Daily* reported it, people did bank-run nationwide. Because of this bank-run he lost his power to manage the economy while Premier Li Peng took it and replaced him as the leader.

The reason why the CCP is very cautious for inflation is that during the civil war period the *Kuomintang* under Chiang Kaishek experienced hyperinflation in Shanghai. The *Kuomintang* (the Nationalist Party) fled to Taiwan after the defeat of the civil war and succeeded in managing the economy by taking lessons from the government failures in Shanghai. Zhao's misjudgement suggested that the government had lost its credibility at this moment. The famous anecdote saying the '*shang you zhengce, xia you duice*' (If there is a policy on the top, then there is a counter-measure at the bottom) truly shows that the government credibility problem.

It is also true of the relations between the government and firms and of those between the central and local governments. For example, the confrontation between the central and Guangdong government concerning open-door policy was the case. This confrontation resulted in the victory of the central government so that Secretary Ye Xuanping (a son of General Ye Jianying) was fired and moved to Vice-Chairman of the Chinese People's Political Consultative Conference.

The move toward trade liberalization came out in the form of tariff cut in order to join the GATT (the present WTO) in the end of 1992. After the entry to the WTO in 2001, China's average tariff of farm products will drop to 15% in 2004 while that of industrial goods to 9.4% in 2005.

In terms of exchange rate policy, on January 1, 1981, the government adopted a dual exchange rate system where the international official rate was 1.9 yuan per dollar and the domestic rate 2.8 yuan per dollar. After the introduction of this dual exchange rate system, the U. S. Textile Industry Association regarded it as a sort of dumping so that it filed a suit against China to the government, making a claim for countervailing duty against China. As a result, the U. S. government did not accept this suit and made the Multi-Fiber Agreement with China in December 1983.

It was not until 1994 that China abolished the dual exchange rate system, adopting a single exchange rate. So far China did not realized convertibility of the yuan. In the beginning of 1994, China devalued the yuan by 24.7% following tariff reduction in 1992. This devaluation was owing to the cautious exchange rate policy of the government. After the Asian economic crisis in 1997, some ASEAN member countries criticized this excessive devaluation. Because they insisted China's devaluation should be a remote

Table 1 Composition of Three Kinds of Prices in the Marketization of the Economy,

1990-99

(unit :%)

		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total Retail	GPPs	29.8	20.9	5.9	4.8	7.2	8.8	6.3	5.5	4.1	3.7
Sales of	GPPs	17.2	10.3	5.1	1.4	2.4	2.4	1.2	1.3	1.2	1.5
Consumer	MPs	53.0	68.8	93.0	90.4	90.4	88.8	92.5	93.2	94.7	94.8
Goods											
Total Purchases	GPPs	25.0	22.2	12.5	10.4	16.6	17.0	16.9	16.1	9.1	6.7
of	GPPs	23.4	20.0	5.7	2.1	4.1	4.4	4.1	3.4	7.1	2.9
Agricultural	MPs	51.6	57.8	81.8	87.5	79.3	78.6	79.0	80.5	83.8	90.4
Products											
Total Sales of	GPPs	44.6	36.0	18.7	13.8	14.7	15.6	14.0	13.6	9.6	9.6
Producer Goods	GPPs	19.0	18.3	7.5	5.1	5.3	6.5	4.9	4.8	4.4	4.8
	MPs	36.4	45.7	73.8	81.1	80.8	81.1	81.1	81.6	86.0	85.6

Notes: 1. GPPs stand for government procurement prices.

2. GPPs stand for government guidance prices.

3. MPs stand for market prices.

Source: *Zhongguo Wujia Nianjin Bianjibu* (The Editing Section of the Price Yearbook of China), *The Price Yearbook of China 1998*, 1998.

cause of the 1997 crisis in Asia.

Liberalization of capital market was not scheduled. However, China became an Article VIII country in the IMF which is under the obligation to remove all restrictions on current exchange transactions on December 1, 1996. Because of this change, China must not regulate exchange of the yuan into foreign currencies in the current account. Originally, China was scheduled to move to the Article VIII country in 2000, but it realized this transition four years ahead of the schedule. It will take a much longer time for China to realize convertibility of the yuan in the capital account. The entry to the WTO will accelerate liberalization of capital markets.

Price reform began with liberalization of consumer goods and non-staple food which were in equilibrium between demand and supply. The government made stepwise adjustment of prices of grains, cotton, steel materials, coal, and electricity which were in short supply. According to Table 1, as of 1999, 94.8% of consumer goods, 90.4% of Originally, China was scheduled to move to the Article VIII country in 2000, but it realized this transition four years ahead of the schedule. It will take a much longer time for China to realize convertibility of the yuan in the capital account. The entry to the WTO will accelerate liberalization of capital markets.

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However, Prof. Stiglitz<sup>16</sup> said price reform in China had of general equilibrium. His view is a sort of post-reform evaluation, so that it is too much favorable to China. If he were right, agricultural policy cycle would not happen which Prof. A. M. Tang and I estimated respectively.<sup>17</sup> China's entry to the WTO will make the government abolish the practice of double-tracking as well as different treatments for domestically sold goods and export goods.

Enterprise reform began in the first phase of economic reforms. The government admitted leasing of property of small-scale and medium SOEs. But It is not too much to say that true enterprise restructuring began with the issue of the Regulations on Conversion of Management Mechanism of SOEs. Now share-holding system is under way. On the other hand, privatization of SOEs is not on the schedule.

There has been no liberalization of wage determination. The "Decision" in November 1993 says that growth rate of average wage rate should be lower than that of labor productivity of an enterprise.

Financial reform started in 1985. Monetary policy lagged behind in a way that banks used administrative means rather than interest rates. In 1994 the government admitted some foreign banks took part in business related to the yuan. In five years after joining the WTO in 2001, China will have to carry out liberalization of interest rates and financial market.

Stock markets and futures markets are still in the stage of experiment. Foreigners can buy only B-shares. Futures markets are not linked with international markets. In October 1998, the government decided to scrap and build 11 exchanges in the nation and to concentrate on three exchanges such as Shanghai, Zhengzhou, and Dalian. This fact shows that markets for shares, futures, and commodities are not necessary well developed.

In terms of fiscal reform, the central government transferred the right to collect taxes from SOEs to local governments in the reform of 'tax for profit' in 1985. Since then, the public finance of the central government had become so weak that the central government could not succeed in stabilizing the macroeconomy. So the "Decision" in November 1993 established the tax assignment system to strengthen the public finance of the central government so that the central government might carry out stabilization

policy. In the case of China, legal reform has been proceeding step by step. For example, the Bankruptcy Law was enacted at the early stage of economic reforms, but its application to a real case has recently started.

In terms of open-door policy, the 18th Session of the Ninth NPC in October 2000 modified the Law on Chinese-Foreign Equity Joint Ventures and the Law on Foreign-Capital Enterprises for the entry to the WTO. Namely, the NPC abolished Articles on the following four points: (1) the balance of income and expenditure in foreign exchange, (2) local purchase, (3) export obligations, and (4) the report of enterprise's production plans.

China's entry to the WTO in December 2001 brought the following obligations:<sup>18</sup>

- (1) agricultural policies: China would have recourse to a *de minimis* exemption for product-specific support to 8.5% of the total value of production of a basic agricultural product.
- (2) services: The opening of finance, insurance, telecommunication, commerce, tourism, foreign trade, shipping, construction, education, public health, and publishing would have quicken.
- (3) trading rights: Within three years after the WTO entry all enterprises will have the right to import and export goods and conduct trade within the customs territory.

It is certain that China's entry to the WTO should hurry up the policy sequencing. Anyway, there are many problems to be discussed. Roughly speaking, an agreeable consensus on how to do policy sequencing is to do in the first liberalization of domestic markets, second that of trade, and third that of capital markets.

## 6. National Market Formation Problems

The "Decisions" in November 1993 showed a blueprint for the marketization of the Chinese economy. This document states:

- (1) to establish a modern corporate system,
- (2) to bring up and develop market system,
- (3) to reform functions of the government and to make a sound macroeconomic system,
- (4) to establish rational distribution of individual revenues and social security system,
- (5) to deepen the reform of rural economic system,
- (6) to reform open-door policy,



- (7) to reform science, technology, and education; and
- (8) to establish a legal system.

Price reform in China has changed from direct to indirect control system. For example, producer's price and consumer's price of foodgrains were unified, and the price differential between them vanished in 1992. Then, the government established the buffer stock system of foodgrains as well as price stabilization policy by price guaranteed system. On the other hand, it is true that the dual-track system still exists partly. But we could see a strong move toward market prices. This development of market economy in China would break through the closed local market structure called the "*zhuhou jingji*"<sup>19</sup>(the warlord economy) the provincial government formed, resulting in a single national market.

Saving of transaction and information costs will lead to promotion of vertical integration of firms as well as to development of financial markets. However, trade in a modern civilized society is composed of establishment of private ownership, making of contracts, and respecting of individuality of traders.<sup>20</sup> It is true of China. It is noteworthy that the "Decision" in November 1993 stresses the establishment of legal system. The most important thing in the modern civilized society is human character, that is, morality. Without morality, trade would not exist. It is very natural that Adam Smith wrote *The Theory of Moral Sentiments* before *The Wealth of Nations*.

Furthermore, in the development process of market economy it is necessary for the state to need industrial policy in order to avoid market failures such as ad hoc taxation, public goods, externality, increasing returns, imperfect competition, and imperfect information markets. Of course, it is natural that industrial policy should be consistent with policy sequencing mentioned above.

## 7. The Essential Principles of China's Economy

Economic reforms in China have often seen several contract systems, including agricultural responsibility systems, economic responsibility systems and management contract systems in the industrial sector, and contract systems in fiscal and financial reform.

I would like to investigate the reason why contract systems appeared in economic reforms in China. My hypothesis is that contract systems have existed in the economic history of China. Taking example, Konan Naito states in his book, *Sincho suibo ron*<sup>21</sup>(*The Decline of the Qing Dyansty*) that there was a contract system where the head

of a local government made a contract with tax collectors in the *Qing* Dynasty.

Contract systems existed in the age of the Republic of China. Prof. Yuji Muramatsu<sup>22</sup> also said: middlemen existed in factories. They were responsible for employment and management of workers and achievement of works. In terms of agricultural organizations, there were agents of collecting rents called the '*zhongbao*' in the land tenure system. Coexistence of concentration of land ownership and small peasantry would lead to the fixed-rental system and the middleman system.

In terms of commerce, the management beyond the owner-operator system formed the '*hegu*'(a sort of joint-stock company). In terms of financial trading, trading needs guarantee of middlemen called the '*zhongren*' or '*baoren*' or '*pubao*.' Prof. Sukekata Kashiwa<sup>23</sup> called contract systems the order of '*bao*' saying that the Chinese society was a society surrounded with so many contract systems. He said that contract systems would exist in human relations and that the origins came from taxation system as well as commerce.

In the light of taxation, there has been a saying of the "*shengguan facai*"(promoting in the bureaucracy and becoming rich). In China, historically speaking, a man who passed the '*keju*' (the examination of engaging government officials since the *Sui* Dynasty)could promote to head of a local government. He made a contract for collecting taxes with his men and carried out rent-seeking activities, so that he accumulated his wealth. This tax farming system was a common phenomenon in the official world of China.

In China, there is a term of the "*guanliao ziben*"(the feudalistic national monopolistic capital). This fact is still found in Deng Xiaoping's economic reforms where the '*guandao*'(official cum broker) occurred.

In terms of commerce, it is middlemen that engaged in marketing of goods.

Prof. Muramatsu <sup>24</sup>concludes:

Intermediate contract systems are found in all the aspects of the traditional Chinese economic organizations such as a landlord and peasants, a wholesale dealer and foremen, a factory and household producers etc. Probably, you could regard contract systems as the most specific things to the Chinese economic organizations, so that contract systems existed before the invasion of foreign capital take root in the social mind of the Chinese.

## 8. Marketization of the Economy and Modernization

It is very difficult how to understand the Chinese economy or how to see the economic behavior of the Chinese in the present as well as the old time.

Prof. Muramatsu<sup>25</sup> depicted 'free competition and human guarantee' as the characteristics of the Chinese economy during the period of the Republic of China. He says in China commercial trade was done within the scope of human guarantee, and only through human relations, i. e., human networks. Although competition was very severe in the market, a merchant had dealings with partners guaranteed by individual persons.

The transaction of this type is true of the overseas Chinese, that is, the *huaqiao* or *huaren*, whereas trade is done within the networks of people from a blood relation and the same local community. It can be said that it is not the 'invisible hand' Adam Smith stressed but the 'visible hand'.

In China, marketing order is not given by the governance or the tradition or the class, but by some private trading organizations, i. e., the guild system, merchants specialized in measurement, the '*douhang*', and middlemen, the '*yahang*'.

In the time of the Republic of China middlemen were involved in every trade and guaranteed every contract. Furthermore, they took brokerage fees and were responsible for collecting sales tax as agents of the government. Merchants knew the fact that they could get much more gains from trades under the marketing system where they paid brokerage fees for the middlemen than under other marketing systems.

Prof. Kashiwa regarded the essence of the Chinese economy as the order of the '*bao*' which means contracting between two parties, that is, the principal and the agents. He infers that under the order of the '*bao*' a price of a merchandise might be equal with a basic price plus risk premium. The order of the '*bao*' added up risk premiums on the basic price of the good whenever trade occurred. In the West insurance system covered risk while in China where insurance system was underdeveloped risk premium was added on the price. Thus he regarded competition in the market of China as the competition of 'addition.' At the same time he regarded competition in the West as the competition of 'subtraction.' As a result, profit in China had of statics while profit in the West had of dynamics Schumpeter has suggested. China had no technological progress but the West had.

We could find consistency between Muramatsu's and Kashiwa's hypothesis through the concept of asymmetric information. Prof. Akerlof<sup>26</sup> initiated the Principle of Lemons where a seller of a second-hand car called a lemon has known shortcomings of his own

car and buyers have no information about the car. If a seller tells a lie about the quality of his car, then good buyers will go out of the market. In order to avert the moral hazard of the seller it is necessary for a third party to guarantee the quality of a second-hand car. In Japan car-owners must have designated repair-shops check their own cars periodically according to the rules of the Ministry of Land, Infrastructure, and Transport. This check plays an important role of the third party in improving the situation of asymmetric information. In China every trade required a middleman because he had a function of the third party. He was an alternative of organizations and institutions in the market so that he had a public function of the market. In this context, it is certain that commission should mean risk premium.

Hicks<sup>27</sup> thought that economic development should be a transition process from a customs economy to a market economy. I think the market order of the contemporary Chinese economy should be a mixture of the customs, the market, and the socialist economy.

For example, in 1992 the Ministry of Agriculture in China issued the Regulations on the Peasants Shareholding Cooperative Enterprises (PSCEs). The TVEs of this type have of a joint-stock company, having the same characteristics as the joint-stock company in the time of the Republic of China. There are five forms of stocks as follows:

- (1) Shares of township and village: peasants jointly hold those shares of which origin was the property in which the collective invested and put additional investment every year;
- (2) Shares of the enterprise: workers within the enterprise jointly hold those shares of which origin are from the property it has accumulated and that of tax reduction and of tax exemption by the state. The shares from the accumulation can be distributed to workers. The workers are allowed not to inherit and transfer the shares but to share in the profit;
- (3) Shares of social corporation: firms, enterprise units entitled with corporation, and bodies corporate own those shares of which origin was the property from funds, equipments, materials, patent rights etc. which these input into this enterprise;
- (4) Shares of individuals: workers and individuals own those shares of which origin was property of funds, investment in kind, technology etc. they put; and
- (5) Shares of foreigners: investors in foreign countries, Hong Kong, Macao, and Taiwan own those shares of which origin was the property of funds, equipments, technology etc. they put.

In terms of the right of shareholders, a PSCE may divide shares into ordinary and

preferred ones. Shares of township and village, those of corporation, those of individuals, and those of foreigners can be ordinary as well as preferred ones. However, shares of corporation cannot become preferred ones but ordinary ones. Shares are transferable under certain conditions while generally speaking, shares are not cancelled. Shares of individuals can be succeeded, transferred and donated.

Taking another example, according to his analysis of the structure of automobile distribution under the franchise system in China, Prof. Hiromi Shioji<sup>28</sup> finds the interesting fact that the more tiers the lower prices. After 1995 the automobile market was in oversupply. Most of distributors who entered the market during the first half of 1990s exited from it so that the number of distributors decreased. However, many tiers of distributors still exist. Why do they exist even in the period of oversupply? The answer is a hypothesis that the more tiers the lower prices. In other words, even if there are more dealers, subdealers have comparative advantage in price competition over main dealers. The reasons are as follows:

- (1) The marketing power of main dealers is weak. Dealers at the top level cannot deal in cars supplied by a carmaker so that they resell a part of cars to subdealers.
- (2) Subdealers become free riders. First, subdealers at the lower level than the third one trade not only automobiles but also the other goods and services so that the marginal costs of the variable cost and of the fixed cost are very small, say, zero in the polar case. Second, as subdealers have no stock of cars they order a car to main dealers after making a selling contract with a consumer. Therefore, their cost of inventory stocks is zero. They pay for main dealers after receiving the money from the consumer and get fees in the same system as a commission system. Third, the trading roots are often different from the distribution roots of cars. There are many cases that even if main dealers receive orders from subdealers, they directly sell and deliver cars to consumers or consumers go to main dealers and take cars. In these cases, subdealers have no delivering costs. Fourth, more than half of subdealers are SOEs under the former Ministry of Commerce, being a pool of surplus labor. These subdealers are involved in car trading in the form of making documents by surplus workers.

On the contrary, he says there are many tiers of dealers in the case of short supply of cars. In the case of short supply, prices at the lower level of subdealers increase and fees with buying cars also increase, which will bring premiums into being. Increases in premiums will accelerate reselling of cars, making tiers of dealers increase.

Prof. Shioji's fact-finding is consistent with my hypothesis. His fact-finding shows that even trading of the most modern good such as cars in contemporary China has

many tiers of dealers, which means the existence of middlemen and the contract systems. Professors Muramatsu and Kashiwa suggested.

Thus, it could be said demise of asymmetric information may lead to modernization of the marketing system in China.

## 9. Concluding Remarks

It seems that economic reforms in China have evolved smoothly. However, in reality they went zigzag because of the severe political power struggle between the softliners and the hardliners. It is not to say too much that the economic policy debates will lead to the power struggles.

The debate between the big bang versus the gradualism approach concerning the transition from the socialist economy to the market economy in the Soviet Union and Eastern Europe brought policy sequencing problems into being. It is true that there are many problems to be discussed. In terms of policy sequencing, however, agreeable points are as follows: the first is liberalization of domestic markets, the second liberalization of trade, and the third liberalization of capital markets. It can be said that the Chinese economic reforms will follow these points.

China's entry to the WTO in December 2001 will accelerate the process of liberalization of markets. According to a study of the Chinese Academy of Social Sciences<sup>29</sup> based on the CGE model, China's entry to the WTO will have following economic effects on the economy in 2005: (1) an increase of 1.53% in real GDP, (2) an increase of 0.58% of real consumption, (3) an increase of 1.75% in investment, (4) an increase of 26.93% in export and that of 25.97% in import, (5) an increase of 3.51% in government revenues, (6) an increase of 4.56% in residents' incomes and a decrease of 2.05% in peasants' incomes, (7) an decrease of 1.57% in the terms of trade, and (8) a 1.85 % depreciation of the real exchange rate.

In terms of industry, the agricultural sector and the automobile industry may have serious damages from the joining to the WTO. Recently the terms of trade between the industrial and the agricultural sectors deteriorated to the agricultural sector so that the protection costs of agriculture increased. The agricultural sector will have surplus labor migrate into the spinning and the apparel industry. The study of the CASS says that the former could absorb 2.82 million workers while the latter 2.61 million workers.

Anyway, China must have social safety net because in essence agricultural problems are the labor market problems.

In terms of industrial sector, in July 2001 China launched the new industrial plan<sup>30</sup> to strengthen 13 industries, including the automobile industry by utilizing industrial restructuring, foreign capital and taxation. China will set the vehicle production target of 3.2 million cars which is 1.5 times as large as the present production and the ethylene production target of more than 9.0 million tons which is as much as the present one in 2005.

It is certain that China's entry to the WTO will accelerate economic reforms all the more.

### Notes

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