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China and the Idea of Economic Reform

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ABSTRACT

Economists studying socialist transition have established a paradigmatic view that emphasizes flexible prices, openness to international trade, minimal government intervention in market operations, and private ownership of productive resources. China's, the largest and best performing transition economy, deviates widely from this approach. This paper explores the conflict between standard prescriptions and Chinese reality. The author concludes that gradual reform is unavoidable, that partially reformed systems can generate huge growth spurts, that economists overstate the importance of ownership, and that the institutional structures of market systems are far more complex than most observers imagine.

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I. On the Economics of Socialist Transition

1. What is economic reform?

China's economic reform is part of a larger movement that encompasses not just the former socialist nations, but the entire world economy. This movement is partly political, but it also rests on the accumulation of economic knowledge. The underlying scientific foundation for the reform movement is the realization that government failure is as important as market failure. Earlier generations of researchers and textbooks assumed that government could resolve economic difficulties and therefore neglected to investigate how the state goes about its work or how government initiatives actually play out. Economists are now increasingly sensitive to questions about the motivation of public officials, the ability of government agencies to collect and process economic information, and the likelihood that government intervention may produce unexpected, and often unwelcome consequences.

2. What is a market economy?

Everyone sees the long-term objective of reform as the creation of market systems. But what exactly is a market system? This is a question about which economists are surprisingly vague. Neither the **New Palgrave: A Dictionary of Economics** (1987) or Palgrave's original **Dictionary of Political Economy** (1894-97) contains an entry under the heading "market economy" or "market system." Economists have a clear idea of the characteristic features (competition, price flexibility) and beneficial outcomes (static efficiency, growth, innovation) associated with market systems. But there is no well-established conception of the operational requirements for an effective market system. What economist can lay out the minimum ingredients needed to create distinctive outcomes of market system, which include continuous pressure to reduce costs, to expand quality and variety, and to develop new products, new services, and new organizational methods to better satisfy customers' requirements? HOW MUCH price flexibility is needed? HOW MUCH contestability of corporate control? HOW MUCH entry, competition, labor mobility, etc.?

Many years ago, Anne Krueger (1974) pointed out that if increased state intervention encourages firms to pursue rent-seeking rather than market initiatives, "there might be some point along the continuum beyond which the market fails to perform its allocative function to any satisfactory degree." Socialist transition poses the opposite question: if reform injects successive doses of market forces into a system initially dominated by bureaucratic controls, at what point does the nascent market system begin "to perform its allocative function to any satisfactory degree"? The initial experience of socialist transition shows that economists have no good answers to such questions.

3. Convergence to U.S. Patterns of Economic Activity?

In 1997, with Western Europe facing double-digit unemployment, Japan's economy mired in stagnation, and Korea belatedly confronting the costs of excessive state intervention and business concentration, the American style of capitalism seems to offer the most promising approach to long-term prosperity and growth. Everyone appreciates the virtue of flexible labor markets, vibrant contestation of corporate control, limited restrictions on entry, and relatively open trade. Japan, Germany, France, Korea and many other economies that have long operated with substantial controls now face growing pressure to move in the direction of a U.S.-style system. Once begun, opening and deregulation can acquire their own momentum as incremental reform undercuts successive elements of the inherited system.

Even if some form of convergence toward the current U.S. system turns out to be the best long-term route for the world's major economies, recent economic history, including the postwar experience of Japan and Korea, demonstrates that sustained economic gains can arise from systems that include large market elements and yet deviate widely from U.S.-style institutional arrangements.

If China or Russia can match the economic achievements that interventionist, semi-market systems have delivered to the citizens of Japan and Korea, future historians will surely see "socialist transition" as a remarkable story of economic success. With their penchant for big investment, devotion to economies of scale, and talk of "pillar industries," Chinese officials certainly seem to lean toward a vision of "socialist market economy" that is closer to the ideas of Chalmers Johnson about Japan or of Alice Amsden about Korea than to the views of free-market advocates like Milton Friedman or Jeffrey Sachs.

4. Discussion of Socialist Economic Reform is Often Ideological

When transition began, many economists seemed to believe that reform governments could create market economies essentially by announcement. The idea seemed to be that market systems are essentially defined by the absence of plans and other interventions. By unleashing the logic of self-interest, a policy of removing restrictions and freeing prices would impel people to create the institutional underpinnings of a market system.

Such thinking led to recommendations for rapid, sweeping reform. International agencies urged Russia's leaders "to move rapidly to give substance to their commitment to a market economy. This involves addressing simultaneously issues of stabilization and structural reform" [IMF 1990, p. 2]

This perspective is allied to the "prerequisites" approach to studies of economic history and development, in which analysts seek to identify crucial factors whose absence is thought to obstruct industrialization or economic growth. In each case, analysts see strong complementarities. They believe that the absence of specific characteristics can inflict terminal damage on development prospects because there is no feasible substitute for certain essential features of industrialization, development, or transition.

This line of analysis has little scientific foundation. The prerequisites approach fares poorly in historical and development studies. The idea of strong complementarities, which implies that market systems cannot function without long lists of specific requirements culled from theory texts, ignores the vast gulf separating the actual functioning of market systems from the precepts of "blackboard economics." Several major difficulties immediately arise.

Economic advice about transition routinely distorts the reality of market systems. A financial analyst states that "'five years ago, banks [in the United States] didn't know whether they were making money in a given product or not.' So they scattered their capital widely in search of top-line growth" (Santoli 1997, 22-23). This (and many other) realities of market economies receive little attention in the transition literature, which bristles with extremism. Thus American policy analysts advised Russia to pursue "immediate and comprehensive price deregulation" so that sellers can "set whatever prices they choose" as a "necessary condition for all the other reforms. . ." (Kahn and Peck, 1991 p. 21) even though governments in the United States and other market systems routinely truncate price-setting capabilities in markets for labor, housing, farm products, education, medical care, insurance, electricity, telecommunications and many other commodities and services. Language indicating that governments "must" implement certain policies, or that specific measures are "necessary" or "required" appear over and over in the transition literature. Such language signals the allegiance of authors to the prerequisites approach.

Economies that achieve rapid growth are retroactively anointed with free market characteristics. Thus Jeffrey Sachs and Andrew Warner explain the performance of group of fast-growing economies including the Republic of Korea by stating that in these economies, "allocative efficiency is especially high" and that these economies "rely mainly on market forces in the allocation of resources and have kept government intervention to relatively low levels. These countries are further characterized by a high degree of market competition, open trade. . ." [1996, p. 2]. Anyone who reads newspapers knows that this description does not fit Korea's economy.

Like many other economists, Sachs and Warner emphasize the link between market systems and "allocative efficiency" (also known as "static efficiency" or "Pareto efficiency"). This is Adam Smith's "invisible hand" result. In the absence of restrictions (and under certain other highly stylized and unrealistic conditions), a competitive economy will achieve maximum output in the sense that it is impossible to raise the production of one commodity without reducing the output of some other product. Competition eliminates slack or waste.

Although avoiding the waste inherent in deviations from Pareto efficiency is clearly desirable (assuming that no costs are involved), there is no theoretical or historical connection between Pareto efficiency and technical dynamism or long-term growth - the objects of socialist reform. What historian has singled out Pareto efficiency as the driving force behind American or Japanese economic growth? Monopoly, state guidance, cartels, and protectionism were important components of long-term economic growth in both nations. No amount of wishful thinking can change the historical record, which shows that growth spurts in Asia's "New Industrial Countries" have occurred under conditions far removed from the free market ideal.

Economists regularly disregard the "theory of the second best." First described by Paul Samuelson in the 1940s, this analysis shows that removing some (but not all) obstacles to a fully competitive economy will not necessarily improve performance. Since no economy escapes deviations from competition (even Hong Kong's government maintains firm control over land - the colony's scarcest resource - and intervenes vigorously in the markets for housing, education and health care), efforts to move any economy in the direction of free market outcomes always require careful justification. As Paul Krugman remarks: "while all perfect markets are alike, each imperfect market is imperfect in its own way. You can't propose a one-size-fits-all policy. . . " (1996, p. 111).

The essential point is that, for reasons extending far beyond the scope of this paper, economists come to the discussion of reform issues burdened with extensive ideological baggage. The precepts of this ideology include an unfounded conviction that static efficiency is vitally important even in a dynamic world; fierce (and unscientific) advocacy of free and flexible markets; and (although this is not on display in the foregoing quotations) a nearly religious commitment to the superiority of private over public ownership.

5. Recent Trends in China's Economy Challenge Ideological Views of Socialist Transition and Economic Reform.

China has the world's largest national population and one of the world's largest economies. China's industrial labor force, for example, probably exceeds the combined industrial work forces of all other developing and transition economies. China is a huge economic success story. The past two decades have brought big increases in every imaginable indicator of economic performance: output, productivity, employment, incomes, exports, life expectancy, height and weight, and so on.

China's success is completely unexpected. No economist anticipated China's immense dynamism. Many (including the present author) doubted that the partial and hesitant reform measures initiated in the late 1980s would substantially alter the growth path of China's economy.

China's immense economic gains are of particular importance to economists because the main characteristics of China's recent growth spurt conflict sharply with an embedded orthodoxy that, as noted above, rests on a peculiar combination of emotion, ideology, and scientific analysis.

This conflict makes the study of China uniquely significant for the economics of development and transition. China's reform success is based on the gradual replacement of state control with market allocation. Market and plan coexist uneasily, with market forces steadily eroding the scope and impact of government decision-making. Reform policy arose from a series of ad hoc adjustments with no sign of a clearly defined national reform strategy until the early 1990s - well into the second decade of reform. National leaders have only limited control over the reform process. Although China appears to have become a (heavily regulated) market economy, property rights remain ill-defined, transaction costs are high, and the share of private ownership remains modest, especially in industry, where the contribution of fully private enterprise to total output does not exceed 10-15 percent.

Each of these significant features of China's reform contradicts orthodox expectations. These conflicts signal the need to replace old shibboleths with some new, as yet unknown, synthesis to which the study of China's economy will make important contributions.

6. Reaction to China's Economic Gains is Tinged with Denial and Disbelief

Thomas Kuhn's brilliant study of scientific revolutions found that, once research has established a scientific paradigm, "novelty emerges only with difficulty, manifested by resistance. . . . Initially, only the anticipated and usual are experienced, even under circumstances where anomaly is later to be observed" (1962, p. 64). Economists have established a paradigm for economic reform. In the orthodox view, successful reform depends on a regime of flexible prices, openness to international trade, minimal government intervention in market operations, and private ownership of productive resources. China's economy deviates widely from this prescription. The reaction to China's recent economic gains represents a fascinating illustration of Kuhnian intellectual dynamics.

Many authors, including some at the World Bank, speak and write about "reform" and "transition" as if China, the largest transition economy, did not exist. Thus John Nellis, responding to criticism of the World Bank' s enthusiasm for privatization: "the sad reality is that in those countries that have avoided, postponed, or tried to conduct slow privatization. . . the outcomes have been even worse [than in Russia, Czech Republic and other nations that implemented privatization] (1997, p. 19). But what of China?

Some express disbelief. China-bashing journalists assert that "Taiwanese investors have been among the most successful groups on the mainland, but fewer than half of their ventures are turning a profit" [Carrel and Hornik 1994; the authors did not respond to inquiries about the source of their information]. Hilton L. Root asks "How has China done so well without a rule of law? The answer is it has not" (1995, p. 19). At a 1996 conference in Taipei, a well-known American economist expressed his evaluation of economic reform in Russia and China by informing the audience that "the Russians have got the reform path about right."

Another variety of disbelief surrounds Chinese institutions. President Clinton's economic adviser, Dr. Laura Tyson, defends U.S. China policy by insisting that "the bulk of American imports from China come not from its state-owned enterprises but from its private or quasi-private sectors" (1997). World Bank publications use the same terminology. But the township and village enterprises to which Tyson refers are no more private than the Yokohama Municipal University or Tyson's current employer, the University of California.

Some observers are eager to believe that disaster is just around the corner. In a paper entitled "The Razor's Edge," Alwyn Young describes the rapid growth of China's imports and exports as "evidence of disease" (1996, p. 4).

A more sophisticated response downplays the importance of Chinese socialism: "China's reform problem is basically the classic development problem of promoting the movement of low-productivity, surplus agricultural labor into industry and services" (Sachs and Woo 1996, p. 5). A huge farm sector certainly made China's pre-reform economic structure quite different from that of Russia and other East European nations. But this hardly diminishes the remarkable nature of recent Chinese achievements. If millions of ill-educated, over regulated, and underemployed farmers represent "advantages of backwardness" (ibid., 3), why do we see no big growth spurts in Egypt, India, Bangladesh, Pakistan, Nigeria and other nations that have long enjoyed such "advantages"?

There can be no quarrel with these authors' rejection of suggestions (from whom?) that "countries of Central and Eastern Europe and the former Soviet Union. . . . [should] adopt the Chinese. . . approach" to reform. But their own eagerness to dismiss China's accomplishments in the reform of socialism suggests an ardent (and ideology-based?) desire to remove Chinese approaches from the menu of possible strategies for other ex-socialist nations.

The idea that China's recent economic gains represent "mere" development seems as shallow as insisting that other nations must follow China's reform path. After all, did not China's pre-reform economy include extensive state controls over prices and resource allocation; collectivized agriculture; a huge complex of state enterprises; a vast and cumbersome array of central, provincial, and local government and party bureaucracies; and the legacy of a quarter-century of centrally planned investments?

We need to move beyond this odd combination of denial, distortion, and diversion toward a dispassionate appraisal of what has occurred in China's economy. We need to investigate the constellation of socio-economic forces that underpin recent developments, to inquire how current trends are likely to develop, to consider the costs and dangers inherent in the present state of China's economy, to examine possibilities for the next stages of the reform process and to ask how a deeper understanding of China's recent experience can illuminate broader issues of economic growth and institutional change.

II. On China's Economic Reform

7. Interactive Reform is the Basic Mechanism of China's Transition

China has now experienced two decades of rapid and uninterrupted growth. Macroeconomic fluctuations remain mild by international standards. This growth spurt coincides with striking qualitative change. The profit motive appears everywhere. Even large state industrial firms find themselves pushed toward adopting the culture of the market. Despite the continuation of various forms of subsidy, agents throughout China's economy are increasingly forced to live with market-generated financial outcomes. Domestic industries, formerly insulated from international market trends, find themselves buffeted by international as well as domestic market forces. Institutional arrangements bend in the face of external pressures. These developments continue to reshape individual attitudes, expectations, and behavior at every level of Chinese society.

How did these changes occur? Conventional policy advice pictures economic reform as a series of changes imposed by decree, much in the style of central planning. China's reform is very different. The initial reform goal was to improve performance by tinkering with the socialist system. Even the slogan **moshitou guohe** (crossing the river by stepping from stone to stone) exaggerates the systematic component of China's early reforms by suggesting a firm objective - the far bank of the river - where none existed.

Early reform efforts were partial and tentative. The current objective of creating a "socialist market economy" is itself a product of reform that emerged only in the 1990s. Official reform policies consistently focus on enabling measures (profit sharing, market opening) rather than compulsion (privatization, bankruptcy). Despite their limited scope, reform initiatives served to erode entry barriers, intensify competition, reduce profit rates, and undermine the growth of public revenue, especially at the central level. The resulting financial pressures continue to push enterprises and policy-makers in the direction of innovation, cost reduction, and further market-leaning policy changes.

This vision of interactive reform, elaborated elsewhere (Jefferson and Rawski 1994ab, Rawski 1995) clarifies important aspects of China's economic system. Erosion of governmental power is both an unintended consequence and a powerful engine of China's reform. The most difficult reform task is to force state enterprises and their employees from comfortably protected niches into the hurly-burly of market competition. The declining revenue share of the state and the emergence of fierce economic competition among China's provinces and localities are essential in motivating serious efforts to attain this difficult and unpalatable objective.

8. Employment Security: How Slow-moving Reform Can Deliver Dramatic Results

Consider the example of employment security. China's state enterprises (SOEs) employ millions of redundant workers. At the start of reform, the lifetime tenure and cradle-to-grave security of these workers were inviolate. Today, hundreds of thousands of state workers are unemployed. Shanghai is the pioneer - by September 1996, its state enterprises had shed a cumulative total of 861,000 (Zheng Jie 1996). In Liaoning, the total of layoffs over three years has reached 840,000 (Lu Hongyong 1997).

Outright dismissal of regular employees in China's state industries is the outcome of more than a decade of financial pressures and experimental responses. Erosion of the tenure system often seemed to move at a glacial pace. There were many small steps.

-- At first, economists like Xue Muqiao dared go no further than to suggest that people consider the cost of ensuring cradle-to-grave security for SOE workers.

-- Expansion of individual bonuses and job mobility forced employers to begin paying attention to links between effort and reward.

-- In the late 1980s, the "labor optimization system" invited managers to separate their employees into core and peripheral groups.

-- In the early 1990s, managers discovered that they could "get away with" reassigning workers to hotels, restaurants, and other service subsidiaries, and then pushing the service enterprises and their employees toward independent business operation. In February 1993, I asked and executive of a Beijing firm (subsequently listed on the Hong Kong exchange) how managers persuaded employees to agree to such transfers. His eyes lit up as he replied "we can fire 3 percent without permission!"

-- The next innovation came when managers invented a new institution, **xiagang** or on-the-job layoffs, in which redundant workers were furloughed on partial salary. In some instances, furloughed workers were required to attend training schools whose top graduates could return to work in place of the next cohort of **xiagang** victims. This arrangement may have created real pressures to improve performance even though few workers were hired and none fired.

Fifteen years of this gradualism brought little reduction in the number of redundant workers, but did produce crucial changes in attitudes. In 1980, 1985, or even 1990, the idea that firms might sack large numbers of SOE workers would have seemed incredible to Chinese workers. But by 1992 or 1993, even the dullest SOE employees must have realized that in the end, the state would not protect their tenure, and furthermore, that the end was coming soon. Announcements that mass layoffs were impossible because China's social safety net remained "incomplete" revealed the demise of the tenure principle.

Tenure for SOE workers died quietly in 1996. By year end, newspapers routinely discussed past and future layoffs, and leaders routinely encouraged local officials to help unemployed workers develop new skills, find new jobs, and support their families in the interim.

9. Financial Pressures Continue to Propel the Reform Process

Chinese firms face unremitting financial pressures. The 1995 industrial census (Census 1995) found more than 20 percent of firms making losses in every ownership category except private firms (which accounted for less than 1 percent of 510,381 independent accounting units above the village level). Over one-fifth of joint-stock firms - all carefully selected for financial strength - lost money in 1995. The ratio of loss-makers among firms with overseas Chinese (41.6%) and other foreign (39.3%) equity participation exceeded the proportion of loss-making SOEs (33.7%). State industry recorded an overall loss in the first seven months of 1996 (Li Tieying 1996). Continued entry of domestic and overseas firms, reduction of tariffs, quotas, and other obstacles to domestic and international commodity flows, and improved domestic transport and communication facilities all promise a future filled with more rather than less competition.

The expanded feasibility of dismissing workers will surely lower the barriers to bankruptcy because, as one Chinese author observes, "the fate of the workers has always been the biggest obstacle to bankruptcy." Forcing growing numbers of redundant workers and loss-making enterprises into involuntary exit carries the further benefit of chipping away at an important barrier to reform of the banking system: politically-mandated loans to support excess workers and their unprofitable employers.

With long-standing policies that shielded workers from the consequences of business failure in retreat, bankruptcy has emerged as a realistic policy alternative. The number of bankruptcy cases adjudicated by People's Courts (**renmin fayuan**) has increased sharply (Yi Jianjun 1996, p. 26; Saich 1997):

1989	98
1990	32
1991	117
1992	428
1993	710
1994	1,625
1995	no data
1996	6,232

The spread of bankruptcy forces the pace of reform in China's legal, judicial, regulatory, banking, and accounting systems. Participants in bankruptcy cases must work out procedures for identifying assets and liabilities and weighing the claims of various creditors. Various localities are struggling to respond to these issues. In the meantime, bankruptcy provokes fierce conflicts among workers, retirees, managers, banks, and other creditors. These struggles corrode the socialist ideals of community solidarity and "eating from one big pot" (**chi daguofan**).

10. An Interpretation of Chinese Economic Reform

In China, official actions, especially the policies of the central government, are only part of the reform story. Preoccupation with the concerns of the center inclines many analysts toward a central planning approach to reform, which portrays bureaucrats (and their economic advisers) as operating on society in the fashion of surgeons reshaping the organs or limbs of a comatose patient (Kornai 1990, pp. 176-78). The resulting preoccupation with "optimal" program design injects an element of fantasy into discussions of socialist transition.

This is not to deny the essential function of public policy. But reform is a **process** rather than an event, and policy decisions represent only one aspect of a complex dynamic that revolves around interactions among reform initiatives, decentralized responses to specific policies, economic trends associated with underlying socioeconomic forces, and changes in perceptions and attitudes within and outside the policy elite. China's experience, with its many unexpected outcomes, offers a particularly apt instance of a reform in which government's main contribution consists of initiating successive rounds of change. China's reform resembles a market process in which decentralized experimentation rather than official fiat is to the principal source of emergent patterns that presage the development of new behavioral norms and institutional arrangements.

This distinction between centrally designed reform and institutional change that emerges from decentralized bargaining and experimentation recalls the separate policy visions of Arthur C. Pigou and Ronald Coase (Jefferson and Rawski, 1997). Pigou taught that the appearance of market failure calls for government to impose an appropriately designed tax or subsidy. Much of development economics follows this tradition by tending "to emphasize problems of market failure and the need for informed official intervention. . ." (MacKinnon 1993, p. 1). The "big push" of Rosenstein-Rodan, the practice of central planning under socialism and wartime mobilization, and many aspects of regulation in today's market economy share similar features. In every case, government must collect and process sufficient information to make informed decisions or to promulgate appropriately designed tax, subsidy, or regulatory systems.

An alternative approach assigns to the state the task of creating conditions to encourage decentralized, unmanaged experimentation in pursuit of new resource combinations that may ameliorate economic problems, reduce waste and inefficiency, or open new paths to higher productivity. This perspective is inherent in the so-called "Coase Theorem," which holds that, in the absence of transaction costs, creation and protection of well-specified property rights will permit interested parties to negotiate efficient solutions to market failures without the participation or knowledge of the state. Although the assumption of zero transaction costs is never attained - certainly not in China - Coase's insight implies that official efforts to clarify property rights and reduce transaction costs can increase opportunities for economic agents to ameliorate inefficiencies through decentralized contracting without direct state involvement.

Andrew Schotter makes a similar distinction, identifying "two views of institutions." The first, which resonates with Pigou's welfare economics, sees social institutions as "sets of rules that. . . are planned and designed mechanisms given exogenously to or imposed on a society of agents." The second, which Schotter traces to Carl Menger, looks "at social institutions not as sets of predesigned rules, but rather as unplanned and unintended regularities of social behavior. . . . that no single individual intended to occur. . . . they emerge or evolve spontaneously from individual maximizing or satisficing behavior instead of being designed by a social planner" (1986, 117-118).

Socialist systems take the idea of centrally imposed rules to great extremes. Verdery (1991, 420-21) writes of "the center's expropriation of all capacity to plan" because "socialism's central imperative is to increase the bureaucracy's capacity to allocate." Planners prescribe not only price, quantity, and commodity flows, but also control the form of business organization, the appointment of managers, the calculation of wages, and the scheduling of business plans and activities. At various times during China's socialist period, planners attempted to assign fuel quotas to each tractor and engine, to schedule meals for hundreds of millions of rural residents, and to manage the childbearing activity of individual women. Virtually every aspect of social life: even friendship, music, and language, became entangled with centrally imposed rules.

How remarkable, then, that China now stands out for its reliance on decentralized competition to generate new institutional patterns governing economic life. Even more unusual is the frequency with which China relies on "a profusion of coalitions doing things independently and without coordination" - Edward Green's (1996) definition of a market system - not only to test alternative arrangements for ameliorating poor performance of state enterprises and other difficult economic problems, but even to develop the systems of property rights that appear as exogenous foundations for the negotiation process envisioned in the Coase theorem.

This whole process exemplifies the gradual formation of institutions envisaged by James Buchanan, who writes that (1979, p. 29, with italics as in the original text)

> A market is not competitive by assumption or by construction. A market *becomes* competitive, and competitive rules *come to be* established as institutions emerge to place limits on individual behavior patterns. It is this *becoming* process, brought about by the continuous pressure of human behavior in exchange, that is the central part of our discipline...not the dry rot of postulated perfection. A solution ... is not predetermined by exogenous...rules....if there is one, [it] *emerges* as a result of a whole network of evolving exchanges, bargains, trades, side payments....At each stage in this evolution toward solution there are *gains* to be made, there are exchanges possible, and...the direction of movement is modified."

Sociologists Mark Granovetter and Richard Swedberg echo this perspective (1992, p. 17)

> institutions are not the kind of objective, "external" realities that they seem. Instead, they are typically the result of a slow, social creation; a way of doing something "hardens" and "thickens" and finally becomes 'the way things are done'. When an institution is finally in existence, people orient their actions to a set. . .

> sanctioned by other social actors, treating the pattern as one that exists out of time and could not be otherwise.

III. Where is China's Economy Headed?

Economists have a poor record of long-term forecasting. Looking only at the period since World War II, our profession failed to anticipate growth spurts in Japan, Korea, Taiwan, Hong Kong, Singapore, and, as noted above, in China. Over the longer term, Simon Kuznets observed that science fiction writers have outperformed economists in predicting the future. Yet the temptation to look forward is overwhelming.

China's economy shows many signs of strength. China's population is literate, ambitious, and entrepreneurial. Thirty years of socialism did not diminish the capacity of Chinese society to produce individuals who are particularly skilled at assembling organizations and networks for the pursuit of financial gain (Rawski 1994). There is a national consensus favoring rapid growth and continued market-oriented reform. Two decades of continuous advance have created momentum and confidence that, as in Japan's period of high-speed growth, themselves become important contributors to the development process.

The muted response to the passing of Deng Xiaoping illustrates China's unity and sense of purpose in this area. The overall direction of economic change is largely independent of the identity of China's political leaders. To be sure, Chinese politicians will continue to engage in fierce struggles to control the levers of power. But these levers of power are no longer closely linked to China's economy. The writ of central policy makers often stops at the doors of their imposing offices, as when municipal governments in Shanghai and even Beijing routinely defy national policy regarding China's automotive industry.

At the same time, China's economy faces many weaknesses, of which we briefly consider only three.

-- when asked to describe their biggest difficulties, Chinese enterprise leaders invariably complain that capital is scarce. If capital scarcity is a general phenomenon, then investable funds are a valuable resource that should generate high returns. Yet the returns to capital are low and declining: Chinese writers often complain that profit rates fall short of the (inappropriately low) lending rates charged by China's banks. This suggests the presence of major weaknesses within China's capital markets.

-- information about China's financial sector confirms this expectation. China's banks, like their counterparts in Japan and Korea, rush to expand their scale of operations without focusing on asset quality. Bank balance sheets conceal large amounts of worthless assets. Although the share of unrepayable loans is widely thought to be as high as 30 or even 40 percent, the banks continue to generate optimistic financial reports while maintaining derisory reserves against bad debts - the 1995 annual report of the People's Construction Bank of China, for example, shows provisions for bad debt and bad accounts amounting to 0.6 percent of outstanding loans (1995, p. 28).

Although soft lending (loans made without reference to commercial criteria) undoubtedly continues, there is also an important and widely overlooked trend toward commercialization of bank operations. One example must suffice: when several companies combined resources to create Nanfeng Chemical Industry Ltd. in Xi'an, "the principals transferred all obligations to the banks, both principal and interest, into the new entity where they become liabilities of the new firm **in order to secure the support of the banks and enhance access to future loans** (Xi'an 1996, p. 25, with emphasis added). Evidently the Xi'an bankers had credibly threatened to withhold credit unless Nanfeng undertook to pay off the bank loans of its predecessors.

-- The travails of China's state enterprises are widely reported. We have already mentioned their low profits and redundant workers. The ratio of liabilities to assets continues to creep upward. Although SOE firms continue to take a huge share of bank loans and pursue vast investments, their share of industrial output, now barely one-third of the national aggregate, continues to decline. Ideologues revel in these difficulties, which confirm their darkest fears about public ownership.

Although mismanagement, waste, and fraud surely exist, the prevalent and generally negative evaluation of state enterprise performance is overdone (e.g. Wen Zongyu 1996, p. 15). China's state industry has increased output, productivity, and exports even though its most productive assets are transferred into new shareholding companies and joint ventures, while unproductive assets remain trapped pending the regularization of layoffs and bankruptcy. The export success of joint ventures, many developed around existing SOE facilities and personnel, shows that the upper tier of state firms is not far removed from international market standards. In many cases, an injection of new funds, extra equipment, updated designs, or extra marketing knowhow from the foreign partner transforms a state enterprise-turned-joint venture into a successful export producer, belying the notion of state firms as incompetent and lethargic.

The main source of SOE financial problems lies in their history, not their ownership. Although most attention focuses on subsidies directed to SOEs, these enterprises operate under considerable financial handicaps. Rough calculations suggest that these financial burdens may equal or even exceed the value of direct and indirect subsidies (Rawski, 1997). Without these burdens, SOE profitability may equal or exceed the financial performance of China's highly touted collective factories (Shougang, 1994). Even with their special burdens, and contrary to the findings of numerous studies, the productivity performance of state industry may match or surpass the accomplishments of the collective sector (Jefferson, Rawski, and Zheng, 1996).

Consider just one example of SOE difficulties: pensions. State enterprises face rapidly escalating pension obligations that must be financed from current revenue. Rural collectives and joint ventures, with which SOE firms must compete, escape such costs because they have few elderly workers. Rising pension obligations come as no surprise. The problem arises because the state, which until recently absorbed all SOE profits (and has continued to extract over 80 percent of SOE earnings during the reform period), neglected to accumulate pension reserves.

The 1993 annual report of General Electric Company shows that pension reserves ($24.5 billion) exceed the value of its property, plant, and equipment ($21.2 billion; see General Electric 1993, pp. 28, 48). An infusion of funds equal to the value of fixed assets would resolve the financial woes of many Chinese SOEs. Alternatively, if General Electric were stripped of its pension assets and required to discharge its pension obligations, its financial position would suddenly resemble that of many Chinese state enterprises. Would critics respond to such a debacle by reviving Adam Smith's (1937, p. 700) dire warning that "negligence and profusion. . . must always prevail. . . in the management of the affairs of [joint stock companies, which have]. . . . very seldom succeeded without an exclusive privilege; and frequently have not succeeded with one"?

State enterprises contain much of China's capacity for technical innovation. Many of these firms are crippled by weak finances. Unlocking their productive potential is no easy task. The government cannot provide huge amounts of fresh capital to replace past profits. There are no simple answers to China's SOE conundrum.

A more general issue arises from the possibility of time constraints within the reform process. The foregoing discussion of gradual, interactive reform ignores possible time limits. This may be a big mistake. Gradual reform required more than 15 years to crack the problem of excessive security for SOE employees. Despite recent progress, even more time will be needed to resolve the issue of excessive security for state enterprises themselves. Will patchwork reform do the job before financial pressures cause large chunks of the economy to buckle? Is it possible, for example, that the liability:asset ratio of state firms, now in excess of 80 percent (Zhang Shaolu 1996, p. 22), will reach 100 percent before gradual reforms achieve a general turnaround in China's state industry?

IV. Conclusions

This brief survey points to four conclusions.

We Are All Gradualists Now. It is time to abandon the heated, but fruitless debate about "big bang" vs. "gradualism." Even the most ardent enthusiasts of rapid transition like Boycko, Schleifer, and Vishny understand that the road from plan to market must be long and tortuous: "improving the ownership structure" by privatizing industry "is only a means to. . . . The ultimate goal. . . [of] efficient performance. . . . [which will require] radical restructuring of [enterprise] operations" that in turn depend upon further reforms law and politics [1995, pp. 153, 155, 126-27].

Semi-market Systems Can Generate Huge Growth Spurts. As critics rail about insecure property rights, the absence of commercial law, internal trade barriers, corruption, and many other difficulties, China's crude semi-market system continues to record massive gains. Even if China's current growth spurt turns sour, the recent economic history of China (and Korea, etc.) shows that achievement of a full market system, or anything remotely approaching a full market system, is not a necessary preliminary to accelerated economic growth, structural change, and technical progress.

Even if convergence to U.S.-style arrangements turns out to be best in the long run, the economic history of East Asia in the current century shows that the long run is long indeed, and that vast progress is possible with institutional arrangements that differ immensely from the (possible) long-run optimum. This history highlights the folly of what Harold Demsetz (1971, p. 160) calls "the nirvana approach" - criticizing actual arrangements by comparing them with the mirage of textbook models.

Economists Overstate the Importance of Ownership. China is the world's fastest-growing economy. Industry is the engine room of Chinese growth, and, as noted above, the share of full or even partial private ownership in Chinese industry remains small. The experience of China, the largest developing nation and the largest transition economy, in accelerating growth without significant private ownership of industrial enterprises, financial institutions, or agricultural land indicates that economists have oversold the issue of ownership.

Economic theory links private ownership to attainment of static efficiency, but static efficiency is not the main object of economic reform. Furthermore, the theoretical connection between private ownership and static efficiency fails in the presence of regulation (Laffont and Tirole 1991). Market structures and institutional arrangements surrounding business enterprises often exercise greater influence over business performance than the nature of ownership. American universities provide an excellent illustration. There is a global market for post-graduate education. In this industry, the United States is Number 1. There is no Number 2. Students from every nation flock to American universities to study every subject, from physics and medicine to Chinese economy and Japanese history. America's university sector features fierce competition between public institutions (University of California), private schools (Stanford, Princeton), and hybrids (Cornell, Pittsburgh). Institutions in the public sector receive government funds but remain largely independent of official control. Their success in sustained head-to-head competition with private rivals for faculty, students, and research funding demonstrates the viability of public enterprise.

In China, the link between public ownership and the serious weaknesses of public-sector industry (SOEs and collectives) is widely exaggerated. The chief cause of financial problems facing China's state industries (and its urban collectives) comes from the past, not from the form of ownership. The long delay in ending tenure for SOE firms (through bankruptcy) and their workers arose not because state enterprises are in the public sector -- after all, neither enterprises nor workers in the township-village sector, another part of China's public sector, enjoy comparable protection -- but because China's government fears that layoffs and shutdowns threaten social stability in China's cities. Transferring ownership of state firms to private shareholders will not assuage official concern over possible instability. Russia's experience shows that government can easily obstruct efforts of new owners to restructure privatized enterprises (OECD 1996).

Privatization is one among many policy alternatives rather than some magic potion for prosperity. From this perspective, China's present plans to transfer growing numbers of state enterprises, especially small and financially troubled firms, to new owners outside the state sector, appear well-founded and highly desirable. There is a trade-off between the quantity and quality of public policy. Removing thousands of firms from government jurisdiction may improve the quality of government operations. It may also encourage government to reduce its own staff. If divestiture contributes to the development of a vibrant private business sector, this will strengthen competitive pressures on the remaining state firms. Divestiture will focus official attention on the need to strengthen the private sector's access to credit and legal protection, and to shelter private firms from predatory revenue extraction. Progress in these areas will increase the private sector's demand for labor, which will help to roll back the greatest obstacle to continued reform of the remaining state enterprises.

Market economies are built on large numbers of complex and intricately connected institutions. China's reform will soon begin its third decade. The past twenty years have brought enormous strides toward a market system. The pace of change has accelerated in recent years. Every month brings a torrent of information about initiatives that will deepen market arrangements in areas like trade, pricing, banking, insurance, law, labor, property rights, capital markets, corporate governance and many others. But as reform rolls ahead, a seemingly endless array of gaps, obstacles, shortcomings, and problems comes to the surface. This combination of success and difficulty provides ammunition for endless debates about the "success" or "failure" of China's reform effort. It also demonstrates the enormous variety, depth and complexity of market institutions. Research on the efforts of China and other transition states to create market economies offers a remarkable window that can provide new and often surprising insights into the structure and evolution of economic systems.

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