MARKET AND SOCIALISM

In the Light of the Experiences of China and Vietnam

Edited by

János Kornai and Yingyi Qian

IEA Conference Volume No. 146

Market and Socialism

This is IEA Conference Volume No. 146

Market and Socialism

In the Light of the Experiences of China and Vietnam

Edited by

János Kornai
Harvard University, USA, the Central European University and Collegium Budapest, Hungary

and

Yingyi Qian
University of California at Berkeley, USA, and Tsinghua University, Beijing, China

palgrave macmillan

in association with the
INTERNATIONAL ECONOMIC ASSOCIATION

First published 2009 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN-13: 978–0–230–55354–5
ISBN-10: 0–230–55354–0

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data
Market and socialism : in the light of the experiences of China and Vietnam / [edited by] János Kornai and Yingyi Qian.
p. cm.
Includes bibliographical references and index.
ISBN 978–0–230–55354–5 (alk. paper) 1. China—Economic conditions—2000– 2. Vietnam—Economic conditions—1975– 3. Mixed economy—China. 4. Mixed economy—Vietnam. I. Kornai, János. II. Qian, Yingyi, 1956–
HC427.95.M373 2008
330.12′60951–dc22 2008029966

10 9 8 7 6 5 4 3 2 1
18 17 16 15 14 13 12 11 10 09

Printed and bound in Great Britain by
CPI Antony Rowe, Chippenham and Eastbourne

Contents

List of Tables and Figures

Tables

Figures

List of Contributors

Julan Du, Chinese University of Hong Kong, China, and London School of Economics, UK

Carsten Herrmann-Pillath, Witten University, Germany

Jinglian Wu, Development Research Centre of the State Council, Beijing, China

János Kornai, Harvard University, USA; Central European University and Collegium Budapest, Hungary

Le Dang Doanh, United Nations Development Programme, New York, USA

David Daokui Li, Tsinghua University and Hong Kong University of Science and Technology, China

Barry Naughton, University of California, San Diego, USA

Stephen Parker, Development Alternatives Inc., Bethesda, Maryland, USA

Louis Putterman, Brown University, USA

Yingyi Qian, University of California, Berkeley, USA and Tsinghua University, China

Vo Tri Thahn, Central Institute for Economic Management, Hanoi, Vietnam

Yijiang Wang, Carlson School of Management, University of Minnesota, Minneapolis, USA and Tsinghua University, China

Chenggang Xu, London School of Economics, UK

Weiying Zhang, Peking University, China

List of Abbreviations

AFTA	Asean Free-Trade Agreement
APEC	Asia Pacific Economic Co-operation
ASEAN	South East Asian Nations
BTA	bilateral trade agreement
SHSE	Shanghai Stock Exchange
CICC	China international Capital Corporation
CIEM	Central Institute for Economic Management (Vietnam)
CPC	Communist Party of China
CPI	Consumer Price Index
CPRGS	Comprehensive Poverty Reduction and Growth Strategy
CPV	Communist Party of Vietnam
CSRC	China Security Regulation Committee
CZSE	Shenzhen Stock Exchange
FIA	Foreign Investment Agency
FDI	foreign direct investment
FIL	Foreign Investment Law
FOC	first order condition
GDP	gross domestic product
GSO	Government Statistical Office
ILHDI	Inclusion List Human Development Index
IPO	initial public offering
MBO	management buy-out
MFN	Most Favoured Nation
NAFTA	North American Free Trade Area
NASA	National Aeronautic Space and Space Administration
NTR	normal trade relations
PBOC	People's Bank of China
PFF	production possibility frontier
PPF	production possibility frontier
SASAC	State-owned Assets Supervision and Administration Commission
SBC	soft budget constraint
SL	sensitive list
SME	small and medium enterprise

SOCB	state-owned commercial banks
SOE	state-owned enterprise
TEL	temporary exclusion list
TVE	township and village enterprise
VAT	value added tax
WTO	World Trade Organization

International Economic Association

A non-profit organization with purely scientific aims, the International Economic Association (IEA) was founded in 1950. It is a federation of some 60 national economic associations in all parts of the world. Its basic purpose is the development of economics as an intellectual discipline, recognizing a diversity of problems, systems and values in the world and taking note of methodological diversities.

The IEA has, since its creation, sought to fulfil that purpose by promoting mutual understanding amongst economists through the organization of scientific meetings and common research programmes, and by means of publications on problems of fundamental as well as current importance. Deriving from its long-standing concern to assure professional contacts between East and West, and North and South, the IEA pays special attention to issues of economies in systemic transition and in the course of development. During its 50 years of existence, it has organized more than 100 round-table conferences for specialists on topics ranging from fundamental theories to methods and tools of analysis, and major problems of the present-day world. Participation in round tables is at the invitation of a specialist programme committee, but 14 triennial World Congresses have regularly attracted the participation of individual economists from all over the world.

The Association is governed by a Council, composed of representatives of all member associations, and by a 15-member Executive Committee, elected by the Council. The Executive Committee (2002–07) at the time of the Hong Kong Conference was:

Sir Austin Robinson was an active Adviser on the publication of IEA Conference proceedings from 1954 until his final short illness in 1993.

The Association has also been fortunate in having secured many outstanding economists to serve as President:

Gottfried Haberler (1950–53), Howard S. Ellis (1953–56), Erik Lindahl (1956–59), E.A.G. Robinson (1959–62), Ugo Papi (1962–65), Paul A. Samuelson (1965–68), Erik Lundberg (1968–71), Fritz Machlup (1971–74), Edmund Malinvaud (1974–77), Shigeto Tsuru (1977–80), Victor L. Urquidi (1980–83), Kenneth J. Arrow (1983–86), Amartya Sen (1986–89), Anthony B. Atkinson (1989–92), Michael Bruno (1992–95), Jacques Drèze (1995–99), Robert M. Solow (1999–2002) and János Kornai (2002–05).

The activities of the Association are mainly funded from the subscriptions of members and grants from a number of organizations. Support from UNESCO since the Association was founded, and from its International Social Science Council, is gratefully acknowledged.

Acknowledgements

The Conference was held on 14 and 15 January 2005 at the Hong Kong University of Science and Technology, China. The responsibility for the selection of papers was in the hands of a Programme Committee comprising the following members:

Le Dang Doahn, United Nations Development Programme, New York, USA
Carsten Herrmann-Pillath, Witten/Herdecke University, Germany
Jinglian Wu, Development Research Centre, Beijing, China
David Daokui Li, Hong Kong University of Science and Technology, China
Yingyi Qian, University of California, Berkeley, USA (Chairman)

The IEA is most grateful to the Centre for Economic Development at the Hong Kong University of Science and Technology, China, who generously agreed to ensure most of the funding of the Conference.

Generous subsidies were also provided by UNESCO through the International Social Science Council.

1
Introduction

János Kornai and Yingyi Qian

Two events have provided the background for the chosen topic of this Round Table. The first is the great intellectual debate in the 1930s known as the 'socialist controversy.' At the beginning, the arguments in the debate were centred on the issue of feasibility of socialism using the market mechanism for resource allocation, but soon they were extended to the more general issues beyond. Among the distinguished participants of the debate are Barone, Taylor, von Mises, von Hayek, Lange, and Lerner. There emerged influential intellectual works as a result of the debate, the most famous being Hayek's 'The Road to Serfdom' and 'The Use of Knowledge in Society' on the one hand, and Lange's 'On Economic Theory of Socialism' on the other. It is in the latter that Lange formulated his famous idea of 'market socialism.'

The second event, one of the most important in the twentieth century, is the rise and fall of the socialist economic system. At its peak, nearly 30 countries comprising one third of the world's population practised socialism: the political and economic system characterized by central planning, public ownership, and the monopoly power of the Communist Party. Since the fall of the Berlin Wall in 1989, all of the countries in Central and Eastern Europe have made the transition to a system characterized by market, private ownership and democracy.

But two countries, China and Vietnam, seem to represent an anomaly. There is no doubt that these two countries have abandoned central planning. It also becomes clear by the turn of the century that private ownership has become a significant, if not yet dominant, force of the economies in these two countries. However, in two important aspects these two countries differ from those countries in Central and Eastern Europe. The official ideology in both countries maintains the claim to adhere to the road of socialism, and both countries continue to have the Communist Party in power guaranteed by the Constitution. China and Vietnam are too large to be ignored or simply regarded as an exception to a general trend. China, with a population of 1.3 billion, is at least three times larger than all the Central and Eastern European countries, including Russia, combined. Vietnam, with a population of over 80 million, is larger than Poland, the largest Eastern European country. Furthermore, the economies of both China and Vietnam have given outstanding growth performance so far.

The reform experiences of China and Vietnam have raised important intellectual, as well as practical, questions. Are they practising market socialism? If not, what kind of socialism are they building up? How has the market emerged under the dominance of public ownership? What is the meaning of the term 'market' in this context? How has private ownership evolved in the presence of the ideology of the Communist Party, which identifies itself with public ownership according to the orthodoxy of Marx? How will the economic development and the transformation of the structure of ownership induce legal and political change? Towards which kind of market system are China and Vietnam heading? Is there an Asian road, different from the European road, towards market and democracy?

These questions touch upon some fundamental issues concerning the relationship between market, property rights, and political system. They were addressed at the Round Table of the International Economic Association on 'Market and Socialism in the Light of the Experiences of China and Vietnam' held on 14–15 January 2005 at the Hong Kong University of Science and Technology, Hong Kong, China. This volume contains 11 chapters based on papers presented at that Round Table.

Chapter 2, by János Kornai, clarifies some conceptual confusions about the terms 'market' and 'socialism.' It serves as a point of departure for the rest of the book. While the interpretation of the concept of market is pretty standard and easy, the interpretation of the term 'socialism' is much more difficult. For the sake of the current discussion, Kornai distinguishes five different interpretations of socialism.

The first interpretation is that by Marx. Marx unambiguously advocated public ownership of means of production because he believed that it is more productive than private ownership. According to Marx, market combined with private ownership of property only means anarchy and waste. On the political structure, Marx did not appreciate 'bourgeois democracy,' and he advocated the dictatorship of the proletariat for an indefinite period of transition from capitalism and communism.

The second interpretation of socialism is the Walrasian concept of socialism. The most influential work is from Oscar Lange, whose model of 'market socialism' fits well into the framework of Walrasian economics. Market socialism means public ownership plus market. Socialism and market are compatible. The first two interpretations of socialism are the concepts envisioned by scholars, and they do not correspond to realities.

The third interpretation is Lenin's concept of socialism. This would be called 'classical socialism', which was practiced in 26 countries for a considerable time. It has three coherent characteristics: the political structure features the unshared power of the Communist Party; public ownership is the dominant form of ownership of property; and market is suppressed and replaced by the predominance of central management, or bureaucratic coordination.

The fourth interpretation is the social democratic concept of socialism, which has been practised by several Western countries since the Second World War. Social democrats unconditionally accept parliamentary democracy and do not reject private ownership. Although they advocate the market as the chief coordinator of economic activities, they are also in favour of using the power of the state for income redistribution to create the welfare state. Both interpretations three and four are socialism found in the real world, in the past or at present.

The fifth interpretation is the contemporary Chinese and Vietnamese version of socialism. Kornai makes a point that it is fairly clear that it does not fit to any of the previous four interpretations. In both China and Vietnam, private ownership flourishes, which is in fundamental contradiction to the first three interpretations of socialism. In reference to the third interpretation of Lenin's socialism, despite the fact that the political structure has remained basically unchanged, market is becoming the main coordination mechanism for resource allocation. Finally, in contrast to the interpretation of social democrats, China and Vietnam have not embraced democracy. They are not building the welfare state. Kornai then raises an important question: what is the true meaning of socialism in the case of China and Vietnam? Chapters in the rest of the book try to address this difficult question.

Jinglian Wu, in Chapter 3, reflects on the Chinese economic reform and the influence of the concept of market socialism on the Chinese reformers. The Chinese became familiar with Oscar Lange's idea of market socialism with the intermediation of the works of Polish economist Wlodzinierz Brus. Brus's key concept is to replace central planning by autonomous market-regulated state enterprises in microeconomic affairs while central planning continues to operate in macroeconomic affairs. It is a variation of Lange's idea of public ownership-cum-market. One of the Chinese reform pioneers Sun Yefang actually proposed a similar idea in the 1950s and 1960s. He proposed centralizing power on major issues (regarding extended reproduction) while decentralizing power on minor matters (regarding simple reproduction of existing funds). However, the post-1978 Chinese reform experiences have shown an interesting twist. On the one hand, official reform strategy did, indeed, proceed along this line of thought, but was mainly restricted to the urban state sector. It turned out not to be very successful. On the other hand, the unexpected success of the rural non-state sector led by the township-village enterprises (TVEs) has guided China to a different route of reform; that is, to develop a non-state sector outside the state sector. This happened to work.

Reform strategy then evolved into focusing on the development of non-state sectors. This was achieved by three means: encouraging domestic non-state enterprises, opening up domestic markets to foreign firms, and establishing experimental areas such as special economic zones. As a result of this reform strategy, non-state sectors led the economic growth. In 1978, the state sector accounted for 78 per cent of total industrial output; by 2001, the state sector accounted for less than 30 per cent of total industrial output. China's reform experience conforms to Kornai's notion of the 'organic development' of the private sector, where natural development of new enterprises in private ownership rather than accelerated privatization drives the growth. Wu concludes that the Chinese experience does not support the strategy of introducing a market allocation mechanism on the basis of public ownership, as the advocates of market socialism (the second interpretation of 'socialism') suggest. China presents a case for ownership reform together with market development in general, and organic development of new entrepreneurial firms as the main driving force in particular.

In Chapter 4, Louis Putterman observes that the Chinese reform prior to 1993 was perhaps within the framework of market socialism, as it was a market-oriented reform without privatization. But by the mid-1990s, China left its rendezvous with market socialism and headed towards a more fully capitalist economy. He argues that China's experience in the 1980s was only an indirect approach towards capitalism, because such a market socialism cannot survive unless legal, political and social constraints prevent a natural transition to market capitalism. Because these constraints were present in China only to a limited degree, China 'orbited' market socialism on its path to market capitalism.

Putterman gives two reasons for the instability of the market socialism practised by China in the 1980s. The general reason is that the combination of natural human self-interest and natural human variability with respect to intelligence, drive, and intensity of self-interest means that a market economy will quickly become a capitalist economy unless there are other barriers to capitalist forms of property. The specific reason is related to the historical context of China in the early 1990s, where external and internal influences all made commitment to market socialism unlikely. An important part of the external influence is the investment from overseas, especially the overseas Chinese from Hong Kong and Taiwan. Neither were internal intellectual currents affected by the ideas of market socialism, which remains, essentially, only a Western concept. The Chinese experience suggests that market socialism cannot be established as a lasting institutional framework.

Weiying Zhang, in Chapter 5, disputes that state ownership is compatible with a market economy. In his view, the Chinese experiment with market socialism – that is, introducing a market mechanism while preserving the domination of state ownership – is a failure. His key argument is that competition is essential and indispensable for the operation of the market, but state ownership is incompatible with it in the sense that competition would eventually wipe out state-owned enterprises. The Chinese experience has shown that, in a state-owned economy, competition often leads to excessive competition. The fundamental reason is that the politicians and bureaucrats who exercise ownership rights of the enterprises do not design the incentives for managers in the same way as private owners. In the market economy with private ownership, capital and managerial labour markets play an important role in disciplining and motivating managers. These markets do not exist in the state-owned economy. Competition is not an exogenous phenomenon independent of ownership. Therefore, it does not make sense to argue that ownership is irrelevant as long as the market is competitive. The evidence in China shows that competition actually has led to privatization, as state-owned enterprises cannot survive for long in a competitive environment.

The joint chapter by Julan Du and Chenggang Xu, Chapter 6, examines China's experiences with market and socialism in the context of its financial market development. China developed a fairly large equity market in the 1990s. This market has two important features: the state is the largest shareholder, and the market is under administrative governance. But the authors of Chapter 6 argue that, in spite of these two features, the Chinese financial market development is inconsistent with the model of market socialism. The dominance of state ownership of the listed companies is only a transitory phenomenon, for two reasons: these listed companies are now issuing more equities to individual investors; and, furthermore, the state shares will become tradable, and the state will sell more of its own stakes to private investors.

Du and Xu studied China's financial market development from 1990 to 2002, with a particular focus on its quota system. Under the quota system, quotas for issuing shares on the stock market were distributed to local governments. They observe a strong correlation between the previous performance of the listed firms and later quota allocations, suggesting that the quota system was a *de facto* incentive scheme to motivate local governments to select better firms at the initial public offering (IPO) stage. Therefore, the administrative governance regime with the quota system worked to substitute for the formal legal institutions, and it also prevented the worst enforcement failures. However, Du and Xu also observe that, although the initial stage of a jump-start of the stock market in China is a success, such administrative governance is not a long-term solution, mainly because it fails to monitor companies once they are listed on the market. Therefore, the administrative governance is capable of *ex ante* screening but is significantly weaker in the post-listing world. Consequently, it cannot be regarded as a workable model for market socialism.

In Chapter 7, Carsten Herrmann-Pillath, using the concept of 'economic culture', proposes an alternative explanation for the Chinese experience with market and socialism. His chapter focuses on two cases concerning the rural economy to demonstrate the evolution of property rights under socialism. The first case concerns property rights on land. Even today, rural land is still defined as 'collectively owned'. But the land use rights are effectively private. He argues that the continuation of collective property served as a guarantee of a particular distribution of land use rights in the rural population which stabilized expectations about the future outcome of reform. Stability of collective property rights also served as an anchor to link migrant workers to their home areas. His second case concerns rural industrialization, where the preservation of collective ownership in TVEs was an efficient institutional solution to industrialization in an uncertain environment at the time. He argues that the rise and decline of TVEs is a case of path-dependent gradualism, where changing performance triggers institutional change.

Barry Naughton, in Chapter 8, studies how China's political hierarchy has shaped China's transition from planning to markets. Naughton points out that although nearly all transactions are carried out through the market, it is still the same political hierarchy that commands ultimate political – and, in some respects, economic – authority. Using a multi-task principal-agent model, Naughton's analysis centres on how the Chinese political hierarchy adapts to changes in the economic environment.

In the first phase of reform, from the late 1970s to the mid-1990s, this hierarchy was 'incentivized' through a series of decentralization initiatives. This is viewed as a necessary response to the introduction of the market. It turns out that the strengthened incentives within the hierarchy also provided the underpinning of the dual-track economic system at the time. Naughton argues that it is precisely this complementarity between the incentivized hierarchy and marketization of the economy that explains the Chinese success of reform in this period.

But this complementarity became obsolete around the mid-1990s and, as a result, the Chinese government changed its strategy in the second phase of reform, from the mid-1990s to the present. It abandoned the dual-track strategy and moved in the direction of a 'regulatory state', with a significant recentralization of management and regulatory power within the hierarchy. The government bundled tasks into more specialized and more clearly partitioned jobs within the hierarchy. This restructured hierarchy is a response to the reality that the economy has already grown beyond the initial plan. However, Naughton is worried that even the restructured hierarchy might not adapt well to the Chinese economy in the future, when the tasks become more complex as China moves to middle-income status.

The subsequent three chapters are about the Vietnamese experience of reform. Le Dang Doahn, in Chapter 9, provides a historical background for the evolution of the market economy with a socialist orientation in Vietnam. Vietnam was influenced by the Soviet Union and China, first in the North, after 1950, and then also in the South, after 1975. The path of economic reform taken in Vietnam resembles that of China, where the turning point was a new Party policy of *doi moi* (renovation) pronounced in 1986. As in China, the 20 years of reform have been very successful. The similarity of the nature of reform between Vietnam and China is remarkable. As in China, the market-oriented reform is also mainly driven by small private enterprises, while the government continues to insist on performing the fundamental role played by the state sector. Vietnam does not seem to follow the path of market socialism either. But, unlike China, the Communist Party in Vietnam does not allow its members to participate in private businesses.

In Chapter 10, Vo Tri Thahn focuses on the post-1986 period in Vietnam, especially the period after the major 1989 reforms. In responding to serious macroeconomic instability, in March 1989 Vietnam adopted a radical and comprehensive reform package aimed at stabilizing and opening up the economy. The macroeconomic stabilization package is a sort of 'shock therapy' similar to that in some of the Eastern European countries at the beginning of the transition. It worked well. Other than that, reforms in Vietnam were remarkably similar to China. Most radical reforms were carried out in the agriculture sector. Household farming replaced cooperatives, and long-term land use rights were granted to farmers to create strong incentives. Similarly, the government encourages domestic private entrepreneurs as well as foreign direct investment (FDI). Rapid growth in services and construction mainly came from the rapid growth of private enterprises. Also, as in China, the reforms in state-owned enterprises and state banks have been limited, despite huge efforts from the government.

What are the lessons from the Vietnamese experience? Vo argues that, fundamentally, economic reform is about granting rights and enlarging opportunities for people so that they can choose and decide the directions and forms of production and business activities that they will pursue. In Vietnam, it is also true that the Communist Party's leadership is the most decisive factor for guiding *doi moi*. But why does the Party insist on the concept of 'socialist orientation' when it pushes for market-oriented reform? Vo explains the three dimensions for which 'socialist orientation' really stands.

The first dimension concerns the leading role of the state sector in the economy. Unlike market socialism, the state sector might not play a dominant role in the economy, but it has to play a leading role. The government does not want to give up that role. The second dimension is the concern about income distribution, specifically the gap between the rich and the poor. It is a concern reflecting the popular hostility against the rich and reflection of the traditional egalitarian tendency in society. The third dimension concerns the goal of a strong nation, which echoes nationalism.

In Chapter 11, Steve Parker takes up the discussion on Vietnam from a different angle, focusing on Vietnam's economic integration with the world. Parker identifies two phases of integration. The first phase runs from 1986 to approximately 2000, the 15 years of relatively gradual reforms. Systematic reforms accelerated from about 2000 to implement the US–Vietnam Bilateral Trade Agreement (BTA), which opened the US market for Vietnamese exports; to implement the ASEAN Free-Trade Agreement (AFTA); and to prepare the accession to the WTO. These three trade agreements provided critical benchmarks, focus and incentives for adjusting Vietnam's legislation, regulations, and administrative procedures in order to conform to international standards and best practice.

The distinct feature of the Chinese and Vietnamese experience is that market and ownership reform occurs contemporaneously with the persistence of the Communist Party's monopoly of power. The joint chapter by David D. Li and Yijiang Wang is an attempt to explain the striking difference between Eastern Europe and the former Soviet Union on the one hand, and China and Vietnam on the other. The experiences of Eastern Europe and the former Soviet Union seem to demonstrate that socialist political and economic systems are coherent, consistent, and intertwined with each other. Market-oriented reform is doomed to fail without fundamental political change. The chapter asks a difficult question: why have Chinese and Vietnamese market reforms worked so far under the rule of the Communist Party? The Chinese and Vietnamese experience is a puzzle, considering what has happened in Eastern Europe.

Li and Wang argue, in Chapter 12, that the initial political conditions in China and Vietnam are fundamentally different from those in Eastern Europe and the former Soviet Union. The Communist Parties in China and Vietnam came to power after long and brutal military action, and thus enjoy an extraordinary level of political and military control. Such control was reinforced by the existence for thousands of years of a feudalistic social structure. Having strong initial political control, the Communist Parties there can afford the moderate easing of political control over economic reform without needing to be concerned about losing power completely. By contrast, in Eastern Europe and the former Soviet Union, economic reforms in the 1980s ran into political barriers and further reforms were impossible without radical political change.

Let us summarize the lessons. The participants did not draw final conclusions. Nevertheless, there was a tacit consensus concerning China, Vietnam and 'market socialism'. *Yes*, both countries are more or less market economies, or close to being market economies. And *no* – neither country can be called a 'socialist system', by any usual definition of the term 'socialism'. The use of this concept is only a characteristic component of the rhetoric applied by the ruling elite of these countries.

While there was a consensus in that respect, the discussion did not lead to conclusive predictions for the long-term development of these countries. The present situation of the state sector of production seems to be unsustainable. But nobody can make strong predictions as to where that leads. To further shrinking in relative, or even in absolute, terms? Or to stronger efforts by the government to force the survival of the state sector by using all its means of political and economic power?

Even less settled is the question of the political future. Participants were sceptical with regard to a mechanical response from the political sphere to changes in the economic sphere; in other words, that the movement in the direction of private property and market coordination will automatically generate a movement towards democracy. But the prospect of a slow and gradual shift towards the state of law and, finally, towards democracy is certainly not out of the question.

2
Socialism and the Market: Conceptual Clarification*

János Kornai

Introduction

The linking of the two terms, 'socialism' and 'market' has a long history. Various combinations and linkages have emerged in the extensive, sometimes rather heated debates, both in academic circles and in the political sphere. For example, 'market socialism' or 'socialist market economy', to mention only two widely used examples.

The main purpose of our Round Table was to look at recent experience in China and Vietnam. The study of the real history of these two countries might help in the reconsideration of the relationship between socialism and market. Also, an approach from the other direction could be quite useful. Recalling the political and academic debates of the past can contribute to a better understanding of the realities in contemporary history. Analysts are at risk of getting lost in minor details. Confronting today's experience with century-old intense debates puts the Chinese and Vietnamese development in a wider historical context.

These debates have, so far, always been blurred by conceptual confusion. The purpose of this chapter, the introductory lecture at the Round Table, is to attempt some conceptual clarification.

Interpretation of the term 'market'

The interpretation of the concept of 'market' is not too difficult. Here, we have – more or less – a consensus. In the present context, I draw your attention to a few properties that characterize the market.

Market is a mechanism for coordinating human activities. It is a social arrangement for the integration of society.[1]

Market is not the only mechanism of coordination and integration. I mention only one alternative – a feasible and powerful one: bureaucratic coordination, for example, which is especially relevant in the context of the Chinese and Vietnamese experience. That served as the main coordinator for decades in these two countries. There are many important differences between bureaucratic and market coordination in the degree of centralization or decentralization, in the nature of information flows, and in the incentives associated with this type of coordination. Market and bureaucratic coordination are only two, albeit especially relevant, examples; history has generated other coordination mechanisms as well. As time goes on, societies choose – deliberately or by spontaneous processes – between alternative coordination mechanisms. Reform in China and Vietnam includes, among other changes, a shift away from the predominance of bureaucratic coordination towards the predominance of market coordination.

Interpretation of the term 'socialism'

While there is a wide consensus concerning the meaning of the term 'market', there are great difficulties with the concept of 'socialism'. Several interpretations exist. What we witness here is not simply hair-splitting linguistic disagreement. On the surface, it appears to be a controversy about the interpretation of a single word. In fact, the conceptual debate is heavily loaded with political values, with the struggle for the realization of alternative visions of a 'good society', and with sharp divisions concerning the strategy leading to the creation of a new order. It is not about words, but about political rhetoric and ideologies. Some of our colleagues at the Round Table had to take into account tactical considerations; they were unable to be completely outspoken, finding it more productive to go around clear-cut definitions. My personal situation is easier, and for this reason I now put aside all 'diplomatic' aspects and face the genuine problems.

I will discuss five interpretations of the term 'socialism'. There are many more, but most of them can be treated as blends or combinations of my five pure interpretations, or as intermediate, temporal, or transitional stages between the pure cases.

Interpretation 1: Marx's concept of 'socialism'

Let us begin with Karl Marx: he was not the first to use the term 'socialism'. The official training in Marxism, as it was practised in the countries under the rule of the Communist Party, liked to use the somewhat pejorative label 'Utopian socialists' for towering figures of intellectual and political history such as Saint-Simon, Owen and Fourier, and contrast their ideas with 'scientific socialism'. The latter allegedly begins with Marx.

Certainly, Marx opened a new chapter in the history of socialist ideas, and his teachings had, and still have, tremendous influence on political thought and action. It seems to be proper to focus on his contribution.

Marx was not eager to give a detailed description of a future socialist system. He even made sarcastic comments on German professors who drew up a blueprint of a desired socialist order in minute detail. He restricted himself to dropping a few hints here and there. His thoughts on socialism can partly be constructed from a negative approach: the features of capitalism he would furiously reject.

Political structure

Marx had no clear design for the political regime of socialism. There are fragments in his works that allow us to build up the organization of his thoughts on the subject.

Marx certainly did not appreciate 'bourgeois democracy'. He was ready to ridicule the emptiness of liberal political ideas. There are often quoted lines where he advocated the dictatorship of the proletariat needed on the way to the fully-fledged Communist system.

Also, he had some truly naïve anarchistic ideas about the political situation at the stage of 'communism'. Since every need will be met, the necessity for any kind of force or repression would automatically cease. The state would spontaneously shrink and finally disappear, and only the rational self-governance of the community would remain.

Marx certainly did not advocate a brutal, repressive, totalitarian Leninist–Stalinist–Maoist state. Nevertheless, dictatorship was not incompatible with Marx, at least for an indefinite period of transition to communism.[2]

Ownership

Under the capitalist system, productive assets are owned and managed by the capitalists. The capitalist class is exploiting the proletariat, not because they are merciless cruel people, but because they are the legal owners of capital. The world has to be changed; it is time to expropriate the expropriators. It emerges from this train of thought that Marx and Engels opted for public ownership. 'The proletariat will use its political supremacy to wrest, by degrees, all capital from the bourgeoisie, to centralize all instruments of production in the hands of the State, that is, of the proletariat organized as the ruling class' (Marx and Engels (1976) [1847]: 504). He did not specify, however, the route leading to the complete centralization of all means of production in the State's hands, and the institutional framework of public ownership.

In any case, Marx had a strong position on the ownership issue. In the Communist Manifesto, he highly appreciated the progressive role of early capitalism in cleaning up the remnants of feudalism in society. But that time was over, and capitalists became a hindrance to progress. He did not make fine distinctions between small and great capitalists; he just wanted to get rid of capitalism for the sake of a more productive new system.

Coordination mechanism

The three huge volumes of Marx's *Das Kapital* are devoted to the study of the market economy. Capitalism is coordinated by the market. Marx's scholarly interest is focused on the understanding of how the market works. His summary verdict is in stark contrast to his admired predecessor in classical economics, Adam Smith. Smith had great respect for the incredible achievement of the invisible hand. Millions of uncoordinated, decentralized decision-makers finally come up with a balanced state of the economy. Marx was not impressed. On the contrary, he regarded the market as a spectacular manifestation of anarchy. He did not study the problem of efficiency carefully but, almost by instinct, came to the conclusion that the operation of the market leads to waste. Once more, his thoughts on socialism can be reconstructed mainly from the negative approach. Socialism must be exactly the opposite of the coordination mechanism at work under capitalism. If that is irrational – coordination under socialism will be rational. It will be a conscious and reasonable allocation of production forces or of labour or of time spent on labour. Marx, as usual, did not offer a blueprint for central planning, but his idea of reasonable allocation is compatible with central planning and incompatible with the market.

Market – as the chief coordinator of a future socialist system – is a sharply anti-Marxist idea. It is completely alien, not only from the words of Marx but – what is perhaps even more important – also from the spirit of Marx's contrast between capitalism and socialism.

Ideology

Marx was among the first social scientists to recognize the important role of ideology. At the same time, he did not claim to be a prophet himself. He probably would have been embarrassed to see what various political groups are doing one hundred years later under the banner of Marxism. He tried to understand the ideologies of capitalism, but did not suggest a new ideology for socialism.

Interpretation 2: the Walrasian concept of 'socialism'

This interpretation emerged in the quiet life of academia. The pioneer of the so-called 'theory of socialism' was the Italian economist Enrico Barone, a disciple of Pareto (Barone 1935 [1908]). Although even early works generated some response in the economic profession, the real break-through came with the seminal paper on the theory of socialism by Oscar Lange, the Polish economist (Lange 1956 [1938]). There were quite a few other economists who subsequently elaborated Lange's ideas in greater detail: first was Abba Lerner, in his influential book *The Economics of Control* (1946). For the sake of conciseness, I will focus exclusively on the Lange theory.

Oscar Lange's model of socialism fits tightly into the theoretical framework of Walrasian economics. In fact, it is a special application of General Equilibrium theory, pioneered by Leon Walras, reaching its later climax in the work of Arrow, Debreu and other contemporary theorists. There is no need to outline the whole train of thought, since our exclusive theme is the interpretation of the term 'socialism'.

In the world of the Lange model, the notion 'socialism' means public ownership – and nothing else. That is the necessary and sufficient condition of calling a system 'socialist'. Read the Lange paper again carefully. You do not find a single word about power, about the structure of the political regime, about ideology. Ownership is the sole concern.

Oscar Lange does not clarify the exact place of public ownership in the total composition of the structure of ownership. Is the publicly-owned sector only a part of the whole economy? Is it the dominant part, or are all the assets owned by the public? I present here my own interpretation. The Lange paper contains the following alternative tacit assumptions: all productive assets of the economy or the dominant part of them are in public ownership. Or it might be assumed that the publicly-owned sector can be perfectly isolated from the rest of the economy.

And now here is the final reduction: Lange's 'market socialism' is a vision of an economy based on public ownership and coordinated by the market. 'Socialism' and 'market' – these two institutional-structural arrangements are compatible.

The Lange model stirred up a great storm. It received vehement attacks in two great waves. The first rejection came in the brilliant essay by Friedrich von Hayek (1935): it was based on the argument that the vast quantity of information and knowledge required by Lange's model cannot be collected, stored and utilized in a centralized way. It is essential to have decentralized incentives for gathering and making use of knowledge. That is assured by the market and private property – which automatically combine incentives and information.

The second wave emerged in the context of the reform of the Soviet and Eastern European socialist economies. The Hayekian argument regarding incentive and information was corroborated by empirical evidence. My own work, inspired by the reform experience, contributed additional arguments for refuting the Lange theory. It seems to be highly improbable to generate the strong incentive to minimize cost or maximize profit, taken for granted in the world of Lange's theory, in a public firm under a soft budget constraint regime.

It is impossible to couple an arbitrarily chosen ownership structure and an arbitrarily chosen set of coordination mechanisms. There is close affinity between certain ownership forms and certain coordination mechanisms. Decentralized market and private ownership belong together.

A further important counter-argument comes from the political and ideological sphere. The smooth functioning of the market depends on the 'climate'. It requires a market-friendly environment. If the politicians ruling a country are sworn enemies of genuine decentralization, the market will be banished to the black and grey area of the economy and cannot become the fundamental coordinator and integrator.[3]

Following the collapse of Communist rule, the ideas of some kind of market socialism appeared here and there, beside other naïve ideas of a 'third way'. These proposals were, however, energetically rejected.

Let us now move away from the academic debate, and have a look at political history. A traumatic schism split the socialist movement around the time of the First World War: two political movements, two programmes, two ideologies separated from each other. And they were not only separated, but they started to fight against each other, at some points with sad or even tragic consequences.

Interpretation 3: the Leninist concept of 'socialism'

Around the time of the First World War, under the leadership of Lenin, Communist parties emerged. I do not intend to follow the history of Communist parties here, starting before taking power, and ending when they lost power in the Soviet Union and Eastern Europe. I focus only on the time when the power of the Communist party had already been consolidated but the erosion of their rule had not yet begun. That is what

I call 'classical socialism'. The best example is Stalin's rule for several decades after having eliminated his enemies and completed the 'expropriation of the expropriators'; that is, completing nationalization and collectivization, but before 'destabilization' started after the death of the tyrant. We could, of course, find historical realizations of the same type of system in other countries as well. Here is the summary characterization of that system.

Political structure

Democracy is despised and rejected in the rhetoric of the Leninist–Stalinist parties. They proudly announce that they exercise the dictatorship of the proletariat. The truth is that we witness here the unshared power of the Communist party. That is a regime where the party has complete political monopoly. All competitors are not only excluded, but also brutally prosecuted and oppressed.

Ownership

Public ownership of practically all the productive assets is a fundamental feature of the system. Confiscation of private property, nationalization and collectivization are core elements of the political programme before taking power, and remain core elements after having taken power. The programme is implemented consistently and with cruel force. Some pockets of private property remain, but their size is almost irrelevant in relation to the dominance of public property.

The Leninist position towards private property is confrontational. Even the minor remnants are looked upon with animosity and suspicion. 'Small commodity production engenders capitalism and the bourgeoisie continuously, daily, hourly, spontaneously, and on a mass scale' (Lenin 1966: 24 [1920]).

Coordination

The overwhelming role of the market is replaced by the predominance of central management. The usual name given to this form of coordination is 'central planning'. A more appropriate characterization is one of bureaucratic coordination, central control, a system of enforced instructions. This is a 'command economy'.

Market coordination cannot be expunged completely. It plays a certain role, partly legally, partly illegally, tolerated in the various forms of the 'black' or 'grey' economy.

Ideology

Marxism (later Marxism–Leninism, or still later Marxism–Leninism–Stalinism or – Maoism) is treated as sacrosanct. Although it cannot keep a perfect monopolistic position in the minds of all people, it retains a monopolistic position in education, in all legal publications, in the media and so on. The official ideology rejects all thoughts that are friendly to capitalism, private ownership, and the market.

According to the official ideology of that regime, the exclusive legitimate user of the term 'socialism' is its own system. The Marxist–Leninist–Stalinist–Maoist position on socialism is definitely incompatible with any significant role of the market.

Interpretation 4: the social democratic concept of 'socialism'

Here, we discuss the first hundred or more years of social democracy up to the 1980s, and leave out of the scope of conceptual clarification the later changes in social democratic thought. The model countries to keep in mind are Sweden, other Scandinavian countries, and, at a later historical stage, West Germany and other countries in Western Europe. The movement of social democracy adheres to a set of principles. They accept and implement these principles when they assume power, but respect them also before winning or after losing an election.

Political structure

Being a social democrat means unconditional acceptance of the idea of parliamentary democracy. Exactly here is the deep dividing line between the two great currents of the twentieth century. Communists want 'socialism' by any means. If you are able to get to power by election, fine. But if not, take power by revolution, by violence, by imposing the will of the party on the people. Social democrats want their own kind of 'socialism' if, and only if, the majority of people are ready to support their programme by voting for their party.

A Communist party, once in power, does not abandon its power, even if it becomes clear that it does not have the support of the majority. It is not ready to test that support by competitive election. In contrast, a social democratic party is ready to give up its power if the election results demonstrate the loss of majority support.

The schism between Leninists and social democrats started with heated debates about tyranny and political competition, the role of parliament and election. Up to the present day, that remains the crucial, decisive criterion to be applied when we wish to distinguish between Interpretations 3 and 4.

Ownership

Social democracy does not reject off-hand private ownership. Old-style social democrats always rejected crude ways of confiscation. Nevertheless, in some countries (for example, in Great Britain) they were inclined to assign a significant role to nationalization. As worldwide experiences (including the disappointing performance of the Soviet Union and the East European countries) cast the shadow of doubt over the efficiency of nationalized industries, the social democrats gradually gave up plans for nationalization and accepted the predominance of private ownership. Still, they are ready to retain a larger segment of the education and medical care sectors in public ownership (typically of the local government).

Coordination

Social democrats unhesitatingly rely on the market as the chief coordinator of economic activities. But they are not for unfettered free competition. On the contrary, they would insist on using the power of the state for income redistribution. The great accomplishment of their political influence is the creation of the modern welfare state with all the well-known attributes: progressive taxation, free or heavily subsidized education and health service, an extended system of state pension, unemployment insurance, financial support for the very poor and so on. Whatever the fiscal problems caused by the expansion of the welfare state are nowadays, social democrats try to preserve what they feel is the main achievement of their political struggle in parliament as an opposition party or, following electoral victories, in government.

Summing up the remarks on ownership and coordination, we arrive at the following conclusion. Social democrats do not want to create a new 'socialist system', one that is fundamentally different from capitalism. What they want is a profound reform of the existing capitalist system. In other words, they would like to see a variation of the capitalist system, closer to their own political and ethical ideals; one that includes:

- Extensive redistribution for the sake of more equity, fairness and justice
- Establishment, maintenance and development of the institutions of the modern welfare state (national health service, free education, pension for all citizens and so on).

Modern social democracy is searching for new ways to overcome the deep fiscal troubles partly associated with the commitments of the welfare state towards the citizenry. The problems are becoming more severe under the pressures of demographic change, the new conditions on the labour market created by new information and communication technology, and the competitive forces of globalization.[4] Nevertheless, certain elements of the traditional social-democratic approach to redistribution and welfare commitments are still maintained.

Ideology

The set of ideas, values, and objectives of social democrats is closely linked to the 'welfare state' and the democratic political process. It was a hundred years ago when the debate between Lenin (the founding father of the Communist stream of the socialist movement) and Kautsky (a highly respected theoretician and party leader in Germany, one of the founding fathers of what became later the social democratic stream) evolved.[5] At that time, both sides of the controversy referred to Marx as the common theoretical source and highest authority. As time passed, social democrats distanced themselves more and more from Marx and, after the Second World War, completely cut off all ideological linkages to Marxism. The 1959 programme accepted at the party meeting of German social democrats in Bad Godesberg opened a new chapter in the history of the movement. European Social Democracy publicly abandoned Marxism, and skipped nationalization as the essential component of the programme. Sooner or later all social democratic parties followed the German example (Przeworski 1985, Hodge 1993).[6]

And now we turn to the theme of our Round Table.

Interpretation 5: the contemporary Chinese and Vietnamese interpretation of 'socialism'?

There is a question mark at the end of the title because I merely raise the question and do not even try to give an answer. If there is an answer, it is uncertain whether it is identical for China and Vietnam. But let us put aside the study of the difference in the understanding of the notion of 'socialism' in these two countries. Even if there is a difference in the answer, it is still legitimate to ask the same question with respect to both countries.

While I do not undertake to reply, I can offer a few negative remarks. The previous part of the chapter outlined four interpretations of the term 'socialism'. What is going on in China and in Vietnam, the present state of affairs and the changes in the foreseeable future do not fit into any of them.

As for Interpretation 1, Marx was an outspoken enemy of private property and expressed deep distrust in the market. China and Vietnam have already allowed the private sector to grow fast and produce the larger part of GDP. Its share is increasing day by day, and the public sector share is shrinking. The predominant part of coordination is left to the market mechanism. Neither China nor Vietnam is a socialist system any longer, if we apply Marx's interpretation of socialism.

As for Interpretation 2, China and Vietnam are not the historical realizations of Oscar Lange's theoretical construct called 'market socialism'. In Lange's abstract world, productive assets are in public ownership. Lange made great intellectual effort to prove that the market is able to fulfil its coordination role *without* the existence of private ownership. True, in the real world of China and Vietnam the market has become the chief coordinator. That might be a welcome change – but, because of the profound changes in the ownership structure, the present state of affairs has nothing to do with the vision of the intellectual school of 'market socialism'.

As for Interpretation 3, China and Vietnam have preserved an extremely important attribute of the Leninist kind of socialism. The political structure has remained basically unchanged. The Communist party has maintained its political monopoly. The party-state has unrestricted totalitarian power. There is no legally admitted political competition between parties and ideologies: any opposition, dissident or truly independent movement is repressed.

On the other hand, the structure of ownership has gone through fundamental changes, giving up the leading role of the state-owned sector. The role of bureaucratic coordination and central management has been drastically reduced and replaced to a large extent by the market. It is far, very far from a classical socialist system, and somewhat close to a typical capitalist system. Also, the official ideology has gone through drastic changes. The Communist party, which traditionally opposed private property and market, has become friendly towards these arrangements. From a vehemently anti-capitalist view of the world, it has shifted toward pro-capitalist values and principles. Today's Communist parties in these two countries are parties friendly to capitalism disguised by Marxist–Leninist slogans, and by faithful references to the thoughts of Mao and Ho Chi Minh.

As for Interpretation 4, the two main attributes of true social democracy are missing. First, dictatorship, single-party rule is preserved, and the idea of a competitive election is angrily rejected.

Furthermore, the old-style communist regime made serious efforts to build up at least some elements of a welfare state in the sectors of education, health care and pension, for all citizens or – with regard to some services – at least, for the employees of public enterprises. In doing so, the former governments were, of course, limited by the low level of production and development. The efforts could not lead to a well-funded modern welfare state. The efforts in some instances even went beyond the limits of affordability and produced a premature welfare state. Now this situation is over. The state has started to withdraw from welfare services for the sake of a better fiscal balance and more efficient competitiveness of the private sector. The extent of redistribution is diminishing; inequality is increasing dramatically; the gap between the rich and the poor is growing. China and Vietnam are not moving (in relative terms, in the pattern of income distribution and social services) in the direction of the social-democratic Scandinavian model, but rather in the direction of an early nineteenth century Manchester model, or some strikingly unequal Latin American countries.

Four emphatic 'no's – a decidedly negative answer to the question as to whether the systems functioning in China and Vietnam can be called 'socialism' according to the criteria associated with the four interpretations described in this chapter.

This is a *factual* observation and does not have any *normative* implications. In my eyes, the label 'socialism' is not a badge of honour. I am not the advocate of Leninist socialism. I do not discuss the issue of whether China or Vietnam 'deserve' to be called socialist countries, or whether they departed from the only true way of Leninism. Similarly, I am not the advocate of social democracy, and therefore do not blame these countries for being far from the social democratic pattern of parliamentary democracy and the welfare state.

'Socialism' is not a registered trademark. No one has the right to give a mandatory and exclusive definition, claiming that his definition is the only legitimate one. If the Chinese or the Vietnamese leadership insists on calling their own regime 'socialist', no one can deny them their right to do so. Of course, it remains an intriguing question for scholars specializing in the study of ideologies, symbols, rituals, and political rhetoric: What is the motivation for that insistence? These leaders took the risk of departing from the Leninist route, and did not join the social democratic route either, but decided to follow a new path in their *deeds*. But why are they so conservative or stubborn in maintaining the old *words* and why do they continue to carry the old labels? Scholars specialized in the study of ideologies will probably have an answer. They might point out that *words do matter*. In the political sphere (or perhaps also in private life) it is often much easier to turn around in your practical actions than to confess that you have become a renegade to your earlier beliefs and values. Turning from Saulus to Paulus – openly admitting the change of faith and accepting all the consequences – is a rare, indeed very rare, exception in political history.

Intellectuals who make their living from written or spoken words are keen to clarify concepts. But life goes on in the midst of conceptual confusion. In this chapter, I have tried to offer some conceptual clarification. In the chapters that follow, we are going to discuss not what the changes are *called*, but their true nature.

Notes

* The author gratefully acknowledges the assistance of Katalin Szabó and Ágnes Schönner.

1. Most textbooks and dictionaries of economics offer a concise characterization of the concept of 'market', and also various classifications of markets. See, for example, Mankiw (2001) or Samuelson and Nordhaus (2004). I am using here, and in later parts of the chapter, the conceptual framework of my book *The Socialist System* (1992).
2. Marx and Engels wrote in the *Communist Manifesto*, that after the victorious revolution the proletariat would assume 'political supremacy'. Later, Engels formulated the Marxist position this way: 'the necessity of the political action of the proletariat and of the dictatorship of the proletariat as the transitional stage to the abolition of classes and with them of the state' (Engels, 1976: 370 [1872]). Lenin quoted the words of Marx and Engels with great emphasis in his famous book *State and Revolution* (1969) [1917], which laid the groundwork for the construction of the Leninist theory on the state and dictatorship. He wanted to demonstrate the theoretical continuity between the ideas of Marx and Engels and his own thoughts on the issues of creating dictatorship and rejecting parliamentary democracy.
3. For a wide overview of the contemporary debate on 'market socialism', see Bardhan and Roemer (1993). My own critical remarks are summarized in Kornai 1993.
4. Exploring the feasibility of a 'Third Way' is certainly a part of the attempts to modernize the traditional objectives of the social democrats and adjust them to the contemporary worldwide economic conditions (see Giddens, 2000).
5. The climax of the debate was the confrontation between the German socialist leader Karl Kautsky, advocating the social democrats' position, and the bitter attack by Lenin in his famous pamphlets 'State and Revolution' (1969) [1917] and 'The Proletarian Revolution and the Renegade Kautsky' (1965) [1918].
6. There is a certain kinship between the traditional social democratic interpretation of socialism and the ideas of 'Christian socialism', and the related concept

of a 'social market economy', a term conceived in postwar West Germany. At the same time, there is a strong demarcation line concerning the accompanying ideology (Christianity versus a strictly secular approach to political and ethical issues). The discussion of this important political and intellectual current is beyond the limits of this chapter.

References

Bardhan, Pranab K. and Roemer, John E. (eds) (1993) *Market Socialism: The Current Debate* (New York and Oxford: Oxford University Press).

Barone, Enrico (1935) [1908] 'The Ministry of Production in the Collectivist State', in Hayek, Friedrich A. (ed.) *Collectivist Economic Planning* (London, Routledge): 245–90.

Engels, Friedrich (1976) [1872] in Marx, Karl and Engels, Friedrich (1988) *Collected Works*, vol. 23 (London: Lawrence & Wishart): 317–91.

Giddens, Anthony (2000) *The Third Way and its Critics* (Cambridge UK: Polity Press).

Hayek, Friedrich A. von (1935) 'The Nature and History of the Problem', in Hayek, Friedrich A. von (ed.) *Collectivist Economic Planning* (London: Routledge).

Hodge, Carl Cavanagh (1993) 'The Politics of Programmatic Renewal: Postwar Experiences in Britain and Germany', in Gillespie, Richard and Paterson, William E. (eds) *Rethinking Social Democracy in Western Europe* (Portland: Frank Cass).

Kornai, János (1992) *The Socialist System* (Princeton and Oxford: Princeton University Press and Oxford University Press).

Kornai, János (1993) 'Market Socialism Revisited', in Peterson, Grethe B. (ed.) *The Tanner Lectures on Human Values*, vol. 14 (Salt Lake City: University of Utah Press): 3–41.

Lange, Oscar (1956) [1938] 'On the Economic Theory of Socialism', in Lipincott, B. (ed.) *On the Economic Theory of Socialism* (Minneapolis: University of Minnesota Press).

Lenin, Vladimir Iljich (1969) [1917] 'State and Revolution', in Lenin, Vladimir Iljich, *Collected Works*, vol. 25 (Moscow: Progress): 381–492.

Lenin, Vladimir Iljich (1965) [1918] 'The Proletarian Revolution and the Renegade Kautsky', in Lenin, Vladimir Iljich, *Collected Works*, vol. 28 (Moscow: Progress): 227–325.

Lenin, Vladimir Iljich (1966) [1920] 'Left-Wing Communism, an Infantile Disorder', in Lenin, Vladimir Iljich, *Collected Works*, vol. 31 (Moscow: Progress): 17–118.

Lerner, Abba P. (1946) *The Economics of Control* (New York: Macmillan).

Mankiw, N. Gregory (2001) *Principles of Economics*, 2nd edn (New York: Hartford College Publishers).

Marx, Karl and Engels, Friedrich (1976) [1847] *Communist Manifesto*, in Marx, Karl and Engels, Friedrich (1976), *Collected Works*, vol. 6 (New York: International Publishers): 476–519.

Przeworski, Adam (1985) *Capitalism and Social Democracy* (Cambridge UK and Paris: Cambridge University Press and Editions de la Maison de l'Homme).

Samuelson, Paul A. and Nordhaus, William D. (2004) *Economics* (New York: McGraw Hill).

3

'Market Socialism' and Chinese Economic Reform

Jinglian Wu

Market socialism, by the definition of Wlodzimierz Brus, one of its exponents, is a theoretical concept (model) of an economic system in which the means of production (capital) are publicly or collectively owned, and the allocation of resources follows the rules of market including product, labour and capital markets).[1] As a modified model for realizing the transition of a socialist economic system, it had a degree of impact on the reforms in Hungary and Yugoslavia between the 1960s and the 1980s. This chapter is an attempt to make some analytical comments on the theory of market socialism based on the experience of China's reform.

'Market socialism' and its leading exponentials

Oskar Lange

During the 1920s, soon after the Soviet-style command economic system – that is, 'wartime communism' – was founded in a somewhat awkward form, the inherent malady of low efficiency was revealed. Against this background, there was a debate on socialism between its 'opponents' and 'sympathizers' in Western countries in the 1920s and 1930s. In this debate, labelled as 'the socialist controversy', Lange had brought forward his famous model of 'market socialism'. In his paper of 1908, Enrico Barone argued that an efficient resources allocation had nothing to do with the ownership of production factors and that, in theory, a planning committee would be capable of setting up the relative prices for the relevant resources by calculation, which are essential to an efficient allocation. Based on Barone's argument,[2] Lange suggested a model established on public ownership (state ownership) in which the planning committee would determine the market prices in line with supply and demand by stipulating a market system. In this market socialism model, the Central Planning Committee has three functions:

1. setting prices for the means of production according to supply and demand;
2. making investment decisions; and
3. distributing social gains (rents and profits) generated from utilizing state-owned production resources.

guided by price signals, enterprises carried out production based on two principles:

1. to set output at such levels that the price of products equals their marginal cost; and
2. to minimize production cost at the optimum output level.

Families could decide freely the quantity of labour to supply and choose how to dispose of their personal income.

Market socialism and Eastern European economic reforms

As a Polish economist of world renown and a Polish politician, Lange's influence on both theories and practice in Eastern Europe had been undoubtedly significant. As a result, market socialism theory had been playing a guiding role in the postwar economic reforms in the then socialist economies, and the theory itself had been further enhanced and developed.

Wlodzimierz Brus (1921–2007), the former Director for Research in the Polish National Planning Committee and Vice Chairman of the Economic Committee of The People's Republic of Poland, was an important successor to Lange's thoughts. He was an exponent of the Polish school of market socialism and a representative figure of the Eastern European school of reform, which rose in the 1960s and 1970s and advocated combining planning with market mechanisms. He put forward the model of central planning with regulated markets, often referred as the 'decentralized model'. His decentralized model had great influence on reforms in all socialist countries. In this model, the decision-making powers of the three tiers – that is, the macro level, the enterprise and the family – were distributed as follows:

1. The top tier is the central government, which sets prices for the means of production, and distributes social gains (rents and profits) from

utilizing state-owned production resources and makes investment decisions.
2. The middle tier comprises enterprises that conduct production according to 'economic parameters' (such as prices, wages, credit, and taxes set by the Central Planning Committee) to pursue maximized profits while maintaining among themselves free contract relationships between buyers and sellers via the market.
3. The bottom tier involves families, who can freely choose how they wish to work and dispose of their incomes.[3]

As Brus later said, the model that he had designed, 'strove for a compromise solution, spinning macroeconomic central planning with autonomy of market-regulated state enterprise'.[4]

Yugoslavia – and Hungary, after the 'new economic mechanism' – were the relatively typical economies that bore the resemblance of a market socialism. However, none of them made a successful case following the thoughts on market socialism. Even the author himself had to rethink the theory in the late 1980s.[5]

Brus's rethink on 'market socialism' was focused on the question as to whether market socialism, which requires independence of firms and true entrepreneurship, is compatible with the dominant public (state) ownership of the means of production. To be specific, the questions include:

1. Whether the state and the state-owned enterprises (SOEs), and the SOEs themselves, could be completely separated. State ownership means the state having full control over the enterprises. As long as this power was denied, the ownership would be meaningless. Furthermore, the relationship between the independent SOEs must be competitive. With such a separation, the grounds for state ownership being advantageous would diminish. A state with a coordinating function would actually destroy the market and permit the command system to return by the back door. After all, it would be very hard to realize such a separation.
2. Even if the separation were accomplished, the SOEs could not act as fully-fledged market players because the managers are agents and have no material foundation for responsibility for risks should the venture fail. They, as emphasized by Hayek, make it highly probable that they will err either on the side of recklessness or on the side of over-cautiousness. An autonomous enterprise with independent power to select its managers could be one way to resolve the matter, but such independence would make the notion of state ownership

meaningless. Therefore, the chances of bringing the behaviour of SOEs closer to the requirements of an effective market mechanism would be greater if such enterprises were removed from state ownership in its traditional sense.[6] Brus then realized that a complete market system would require the abandoning of any doctrine of ownership. The only form of market socialism in the future would be a mixed economy. His redefined 'real' market socialism is *de facto* divergent from the original definition.[7]

A Chinese version of market socialism and its impact on Chinese economic reform

Reform based on a centralized system in China can be traced back to as early as the delegating of decision-making power and the relinquishing of elements of control in 1958, which featured administrative decentralization from the central to the local authorities. The reform, similar to Nikita Khrushchev's *sovnarkhoz* reforms in the Soviet Union in 1957, was focused on the transfer from central to local governments of planning control, control over enterprises, the power to allocate material resources, the power to review and approve capital construction projects and the administration of credit, labour management, the administration of finance and tax-collection. The decentralized planned system, created by layer-upon-layer transfer of power to local governments at all levels within the overall framework of a planned economy and administrative resource allocation, led to a serious situation. This resulted, among other things, in plummeting production, mounting losses for enterprises, and increasing shortages in supplies of daily necessities. This caused the economy to slide into abysmal difficulties and to a return to central power and, together with it, the defects of the centralized system, which in turn caused another round of reform. However, the reform was not possible until after 1976, when the Cultural Revolution came to an end. During the years of the Cultural Revolution, the market system was considered to be an ideological and political equivalent to capitalism and, as a result, it was suppressed as 'reactionary revisionism'. Following the end of the Cultural Revolution, the appeals and advocation for market rules and autonomous rights of SOEs were free to be heard.

Sun Yefang's model of 'centralizing power on major issues while decentralizing power on the minors'

Sun Yefang was one of the major representatives of the economists who advocated increasing the autonomous rights of SOEs under market regulation. As early as 1956, he suggested that the plan should be based on 'the law of value'.[8] Based on his understanding of socialism, Sun proposed to 'promote the position of profit targets in the planned economic management system'.[9] With this idea as the essence, Sun designed his model of socialist economy. The key of the model was, in his words, 'to centralize power on major issues while decentralize power on the minors', and the criterion of 'major' and 'minor' was the scale of investment funding. 'Power on major issues' (to be retained by government) referred to decision-making power with regard to extended reproduction of the fund, while 'power on minor issues' (to be granted to enterprises in line with the law of value) referred to decision-making power with regard to simple reproduction of the existing fund. In other words, the main feature of Sun's model was to offer more autonomy to enterprises in their daily decision-making (decisions on 'simple reproduction') under the condition that state ownership and state planned management of enterprises' investment decisions were maintained.

It can be seen that Sun's model and Brus's model were essentially the same. I remember Brus and Sun Yefang meeting in Sun's hospital in 1980, when Brus visited China. They seemed like old friends on their first-ever meeting and talked cheerfully in Russian.

Sun Yefang had criticized the strategy of transferring administrative functions to lower levels all along. In a direct letter to the top leaders in charge of economic affairs in 1961, he pointed out that the core issue of the economic management system was not the relationship between central government and local governments; rather, the issue was 'the power and responsibility of enterprises as independent accounting units as well as their relationship with the state, or, in other words, the independent power of operation and management of enterprises'. According to Sun, only if an enterprise has power can the state arouse its enthusiasm to shoulder the responsibilities given to it by the state. He believed that unless this problem was solved, it would not be possible to resolve the issues of the relationship between central government and local governments, or between line ministries and regions. In his view, 'the state can only mobilize the enterprises' incentives to accomplish the state's requirements when the latter have "rights"'. The problem in relations between central and local governments and between the lineal and regional administration could be solved only with the realization of the autonomy and independence of the SOEs for their operation.[10]

This kind of inclination towards market socialism could not be accepted and allowed by the authority at that time. As a result, Sun was criticized as being 'worse than the Soviet economist Ecsei Liberman who advocated market socialism reform' in 1964, and later in 1966, he was even put in prison labelled as 'a reactionary revisionist' and even 'a Soviet spy'. After the close of the Cultural Revolution, most economists and leaders agreed with Sun Yefang's viewpoint; that expanding the autonomy of enterprise and boosting enterprise vitality should be the core of reform. In such theoretical economic circumstances, decision-makers responded. At economic working meetings – principle discussion meetings and planning meetings – held by the State Council in July–September 1978, Li Xiannian, then Vice Premier of the State Council, pointed out in his report that 'a major mistake of the past 20 years of economic system reforms was putting too much emphasis on the division and transfer of administrative functions, leading to a vicious cycle of 'decentralization–recentralization–decentralization'. A certain degree of independence should be granted to all enterprises in future reforms, making them 'actively instead of passively carry out economic accounting and increasing overall economic efficiency.'[11] Li's idea appeared in the decision of the Third Plenary Session of the 11th CCCPC in December 1978. The communiqué of the session pointed out that 'More power should be delegated to lower levels under unified leadership. Local governments as well as industrial and agricultural enterprises should have more autonomy of management under the guidance of a unified state plan', so as to bring into play the initiative, enthusiasm, and creativity of central departments, local governments, enterprises, and individuals, thus resulting in 'prosperity of all sectors of the socialist economy'.[12]

In practice, Sichuan Province initiated the reform of expanding enterprise autonomy to delegate power to and share profits with enterprises. In October 1978, Sichuan Province delegated power to six selected enterprises and achieved good results. Later, the experiment in Sichuan Province was extended to 100 SOEs. In July 1979, the State Council released a series of official documents, including *Provisions on Enlarging the Decision-Making Power for Operation and Management of State-Run Industrial Enterprises, Provisions on Implementing Profit Retention in State-Run Enterprises, Interim Provisions on Levying Fixed Assets Tax on State-Run Industrial Enterprises*, and *Interim Provisions on Implementing Full Loan Financing for Working Capital in State-Run Industrial Enterprises,* requesting all local governments and central departments to select some enterprises in order to experiment with the expansion of enterprise autonomy in line with these regulations. By the end of 1979, the number of experimental enterprises had reached 4,200 nationwide. In 1980, the experiment expanded to 6,600 large- and medium-sized SOEs, which accounted for

60 per cent of the national budgeted industrial output and 70 per cent of national industrial profits. During the first few months of the experiment, employees in experimental enterprises were strongly motivated to increase output and profit. However, as with Russia's 'Kosygin Reform' in 1965, the limitations of the reform soon became apparent. The economic orders were distorted and in chaos, with rapidly increasing fiscal deficit and inflation. The reform, in turn, was contested. By the end of 1980, the government decided to launch an adjustment to the national economy, and the reform of the SOEs shifted from 'expanding enterprises' autonomous rights' to 'accountability', which placed the emphasis on accomplishing state tasks.

Although the 'market socialism' type of reform that empowered the SOEs with autonomous rights under market regulation in the late 1970s was a failure, a similar trial and error experiment was repeated in later reform efforts in China. For instance, 'Provisional Regulations on Increasing Autonomous Rights to State-owned Industrial Enterprises' was issued in May 1984, which was also known as 'The 10 rights increasing' document. In July 1992, the government effected another regulation – 'The Regulation of Transforming the Operational Mechanism for the State-owned Industrial Enterprises', which stressed the autonomous rights of enterprises on operation, sale, pricing, purchasing, import and export, and even allocation of the assets.

The most significant measure to increase enterprises' autonomous rights was the 'Enterprise Contract System', implemented nationally in the state-owned commercial and industrial enterprises in 1987.

Why had the reform of expanding enterprise autonomy failed to achieve the expected success? The mainstream arguments of the leading government departments in charge of SOE reform attributed the failure to insufficient delegation of power and profit sharing. They then suggested adopting the 'household contract system' – which, by nature, was a private farm system that achieved tremendous success in the rural sector in 1980s – for the state-owned industrial and commercial enterprises; that is, the 'enterprise contract system'. There was a pilot project organized by the State Economic Committee, Ministry of Finance and other departments in as early as May 1979 in which eight SOEs in Beijng, Tianjin, and Shanghai, including the Capital Iron and Steel Co., were selected to implement a reform with a profit retaining arrangement at the core. In 1981, the experiment in the Capital Iron and Steel Co. functioned as a progressive profit handover system, which fixed a 7 per cent annual increase of the profit handover to the state, and the company retained the entire surplus. The state, in turn, did not allocate investment to it. This method was in effect till the mid-1990s.

In mid-1987, a decision was made on implementing various forms of enterprise contracting systems in the state-owned enterprises to provide full autonomous rights, after the planned coordinated reforms on pricing, public finance, and the financial sector were suspended at the end of 1986. The basic principles of the contracting system of SOEs were fixing the base quota, guaranteeing the remission, retaining what exceeds the quota, and making up what falls short of the quota. Under this system, the managers of the SOEs gained tremendous power in terms of autonomous operation. However, as Brus stated, state ownership has nothing left whenever the insiders obtain sufficient power. The enterprises contracting system did result in insider control. It neither gave enterprises full managerial autonomy nor promoted the separation of government administration from enterprise management or fair competition among enterprises. Because, after granting the residual control and residual claim to the party awarded the contract, the definition of the enterprise's property rights became more obscure, the conflict of interest between the two parties was intensified, and mutual infringements by both parties became more likely to occur. By the end of the 1980s and beginning of the 1990s, except for a very few exceptions, people in all walks of life, including those in business circles, no longer thought the contracting system was a good way to reform SOEs in China.

Non-state sector led: the reform strategy with Chinese characteristics

When the reform of expanding the autonomy of enterprises in the state sector fell into difficulty, the Chinese leaders, headed by Deng Xiaoping, shifted the focus of reform from the urban state sector to the rural non-state sectors.

The new reform strategy in China: a move initiating from the non-state sector

A major measure was lifting the ban on 'contracting output quota to each household'. In September 1980, the central government decided to allow peasants to carry out the household contracting system by choice. Within only two years, the household contracting system, or the family farm system, replaced the system of three-tier ownership with the production team as the basic unit of people's communes among the overwhelming majority of the peasant population nationwide.[13] The rural economy took on an entirely new look. Township and village-owned enterprises (TVEs), mainly collective-owned, were springing up vigorously under such favourable circumstances. From then on, China adopted a new strategy, different from that of the Soviet Union and Eastern European countries that emphasized reform of existing SOEs. Instead of making major reforms in the state sector, China's reform efforts focused on non-state sectors, aiming at establishing market-oriented enterprises so as to let them drive the growth of the economy. The new strategy was called the strategy of 'outside the system' preceding 'inside the system', or the strategy of 'Incremental Reform.'

After the initial success of incremental reform in agriculture, the Chinese government applied it to other industries to promote the growth of non-state sectors. In addition, the already implemented policy of opening its markets to the outside world generated a number of joint ventures of mixed ownership with foreign investment in coastal regions. Gradually, these non-state enterprises became the main force in China's economic development.

The strategy for the development of the non-state sectors was carried out by encouraging the growth of non-state enterprises, integrating some regions into international markets by opening markets to the outside world, and implementing 'regional advancement' of reform and opening-up by establishing experimental areas.

Encouraging the growth of non-state enterprises

Together with the effort by the government to eliminate ideological and policy impediments to the development of non-state sectors, collective-owned and individually owned TVEs sprang up like mushrooms. Between 1979 and 1988, the number of peasants working in industrial and commercial TVEs reached 100 million. Private enterprises also started to develop after 1983. For instance, in the late 1970s, although private merchants were allowed to export goods to distant places, it was proposed as an expedient for employment. Since 1980, the Chinese government has made a distinction between individual enterprises with fewer than eight employees and larger enterprises, and described the former as the 'individual business sector', as opposed to the then prohibited 'private sector'. As the economic activities of non-state sectors were mainly market-oriented, local markets in some areas gradually came into being, and market forces began to play an increasingly important role in resource allocation.

Integrating some regions into international markets by opening markets to the outside world

During the initial period of reform and opening-up, loans from foreign countries accounted for a greater part of foreign capital than FDI. Since the 1990s, FDI has increased rapidly and become the major form of incoming foreign capital. In the early years of reform (1979–85), total FDI was only US$7.4 billion, but it rose to US$18.6 billion between 1986 and 1991.

Opening Chinese markets to the outside world facilitated domestic economic reform. To survive competition, it was definitely necessary for Chinese enterprises to operate more autonomously and improve production operations and management. Participating in competitive import and export markets also brought the domestic price structure closer to the international norm, and thus accelerated price reform.

Implementing 'regional advancement' of reform and opening-up by establishing experimental areas

Because market-oriented reform could not be carried out throughout the country simultaneously, and the reform had to be systematically conducted, setting up experimental areas in some coastal regions – where both developed markets and suitable conditions were available – was a good choice. When such areas applied the two approaches of reform and opening-up (encouraging the growth of non-state enterprises and integrating into the international market) in combination, a regional 'small climate' was created in which the new economic system could run effectively, to a certain degree. Such successful experiences would also provide examples for inland areas and drive reform there. Facts proved that this was another effective approach for reform – regional advancement.

To ensure the survival and development of non-state enterprises in an environment where the system of allocating resources by plan had not yet been changed, the Chinese government made a special institutional arrangement; namely, the dual-track system in price and other aspects, which enabled non-state enterprises to obtain a supply of raw materials and sell their products via a market economy.

The effect of the new strategy

The new strategy made a break in the dilemma of the market socialism-oriented reform and created a new beginning for real market-oriented reform in China.

Non-state sectors immediately displayed their advantages on their emergence and grew with each passing day. In the 1980s, the growth

Table 3.1 Gross industrial output value by ownership (%)

Year	1978	1980	1985	1990
SOEs	77.6	76.0	64.9	54.6
Collective enterprises	22.4	23.5	32.1	35.6
Others*	0.0	0.5	3.0	9.8

*'Others' include private enterprises and foreign-invested enterprises.
Sources: National Bureau of Statistics, *China Statistical Yearbook* (*Zhongguo Tongji Nianjian*) (Beijing: China Statistics Press), various years.

Table 3.2 Total retail sale by ownership (%)

Year	1978	1980	1985	1990
SOEs	54.6	51.4	40.4	39.6
Collective enterprises	43.3	44.6	37.2	31.7
Others*	2.1	4.0	22.4	28.7

*'Others' include private enterprises and foreign-invested enterprises.
Sources: National Bureau of Statistics, *China Statistical Yearbook* (*Zhongguo Tongji Nianjian*) (Beijing: China Statistics Press), various years.

rate of industrial output of non-state sectors was about twice that of the state sector. In the mid-1980s, non-state sectors – including the collective sector, the individual business sector, and the private sector – came to occupy a decisive position, either in industrial production or in the whole national economy. Their output in the industrial sector amounted to more than one third of the total (see Table 3.1 above). This grew even more rapidly in the retail industry (see Table 3.2 above).

Incremental reform over more than 10 years brought fast growth to the Chinese economy. During the 12-year period from 1978 to 1990, GDP grew by 14.6 per cent annually, and the per capita disposable income of urban residents grew by 13.1 per cent annually (see Table 3.3 overleaf).

From 'incremental reform' to 'overall advancement'

Because the strategy for reform failed to be amended in time, intense conflicts occurred between the invigorated outside-the-system sectors and the inside-the-system sectors, which were still fettered by the traditional economic system. Many loopholes existed in the economic system, and stable economic development was constantly threatened. As Masahiko Aoki (1938–) pointed out,[14] because various institutions in a system are

Table 3.3 Economic growth during 1978–90

Year	1978	1980	1985	1990
GDP (RMB billion)	362.41	451.78	896.44	1,854.79
Total industrial output (RMB billion)	423.70	515.40	971.60	2,392.40
Total exports and imports (RMB billion)	35.50	57.00	206.67	556.01
Total exports (RMB billion)	16.76	27.12	80.89	298.58
Total volume of retail sales of consumer goods (RMB billion)	155.86	214.00	430.50	830.01
Per capita disposable income of urban residents (RMB)	343.4	477.6	739.1	1,510.2

Sources: National Bureau of Statistics, *China Statistical Yearbook* (*Zhongguo Tongji Nianjian*) (Beijing: China Statistics Press), various years.

strategically complementary, when one or more institutions change, other institutions either change accordingly or obstruct the implementation of the new institutions due to their incompatibility with the new institutions. Therefore, system change should be of overall advancement in nature, although the change can be implemented in steps. Otherwise, expensive reform costs will be generated.

As early as 1986, the Chinese government – State Council – conceived a coordinated reform that focused on price, taxation, and fiscal systems. To implement the proposed coordinated reforms, the State Council set up the Economic System Reform Programme Design Office in April 1986. Under the direct leadership of the State Council and the CCCPC Leading Group on Economic and Financial Affairs, this office drew up plans for coordinated reforms with a focus on price, taxation, finance, banking, and foreign trade in the early stages of the Seventh Five-Year Plan. In August 1986, these plans were approved by the Standing Session of the State Council and supported by Deng Xiaoping himself. He spoke highly of them on 13 September 1986, when hearing the debriefing of the CCCPC Leading Group on Economic and Financial Affairs, and instructed officials to carry them out accordingly. However, the leader of the State Council changed his mind in October that year. Instead of implementing the coordinated reforms in price, taxation, government finance, banking, and foreign trade, he changed direction and focused on the reform of SOEs. The so-called 'five major contracting systems' – namely, the enterprise contracting system, the department contracting system, the all-round fiscal responsibility system, the all-round foreign-trade responsibility system, and the system responsible for loans by regions – were carried out in 1987 and 1988. These measures took reform back to the traditional – and unsuccessful – way of maintaining both a market economy and a planned economy simultaneously.

A new upsurge of reform and opening-up did not take place until the beginning of 1992, when Deng Xiaoping made his famous South China speeches to promote further reform and opening-up. In October of the same year, the 14th National Congress of CPC set the reform target of establishing a socialist market economy. In November 1993, the 'Decision on Issues Regarding the Establishment of a Socialist Market Economic System' was adopted in the Third Plenary Session of the 14th CCCPC, and important breakthroughs were made on the following issues:

1. The new reform strategy of 'overall advancement with key breakthroughs' was explicitly put forward, demanding that the reform should not be confined to peripheral issues, but firmly carried out in the state sector. The socialist market economic system should begin to take shape by the end of the twentieth century.
2. A blueprint was drawn up for reforms in key areas, including the fiscal and taxation system, the banking system, the foreign exchange control system, the enterprise system, and the social security system.

From the beginning of 1994, the Chinese government took important measures to implement reforms in these five key areas. Meanwhile, the State Council ordered experiments with the aim of establishing a modern enterprise system according to Company Law, experience from which could be transferred to other entities. Since then, Chinese reform has entered a new stage of overall advancement.

By the mid-1990s, China's reform had progressed to establish a market economic system and adjust the structure of ownership. The fundamental indicator of progress was that the state sector no longer dominated the whole economy, and its share of the national economy was significantly reduced. However, the bottleneck to reform – the establishment of the ownership foundation of a market economy – had not been resolved. As late as 1993, despite the fact that scarce economic resources were still in the hands of the government and SOEs, the state sector accounted for less than half of GDP.

Another historic breakthrough in state sector reform occurred at the 15th National Congress of CPC in 1997, at which the Soviet viewpoint that 'the higher the proportion of the state sector in the national economy, the better' was discarded. Public ownership as the mainstay of the economy and allowing for diverse forms of ownership to develop side by side was stipulated as the basic economic system in the primary stage of socialism for at least 100 years. To achieve it, the following three adjustments on ownership structure are necessary:

1. to reduce the scope of the state sector and to withdraw state capital from industries non-essential to the national economy;
2. to explore diverse forms of public ownership conducive to the development of productive forces and to develop diverse forms of public ownership; and
3. to encourage the development of non-public sectors of the economy such as the individual business and private sectors of the economy and to make them important components of the socialist market economy.[15]

In 1998, this decision of the 15th National Congress of CPC was incorporated into the 'Amendments to the Constitution of the People's Republic of China'; specifically:

> In the primary stage of socialism, the State upholds the basic economic system, with public ownership playing a dominant role and diverse forms of ownership developing side by side... The non-public sectors of the economy, such as the individual business and private sectors of the economy, within the limits prescribed by law, are important components of the socialist market economy... The State protects the lawful rights and interests of the individual business and private sectors of the economy.

Against this background, however, there is still a question waiting for an answer: How to establish the rule of law and constitutional democracy. An embryonic form based on mixed ownership and market rules is developing before us (see Table 3.4).

Nature of the incremental reform

It is worth studying why incremental reform strategy could lead to success for the reform in China. Some studies discussed China's strategy in the dichotomous framework of 'shock therapy' and 'gradualism', frequently referred to regarding the transformation of the former Soviet Union and the Eastern European countries in 1990s. In this regard, I agree with Professor Kornai's critique on the dichotomy. He points out that the only difference between labelling one approach 'shock therapy,' and the other 'gradualism,' was speed, which is by no means a good

Table 3.4 GDP by ownership* (%)

Year	State sector	Collective sector	Private sector**
1990	47.7	18.5	33.8
1995	42.1	20.2	37.7
1996	40.4	21.3	38.3
1997	38.4	22.1	39.5
1998	38.9	19.3	41.9
1999	37.4	18.4	44.2
2000	37.3	16.5	46.2
2001	37.9	14.6	47.5

Notes:
* Quoted from Xu Xiaonian and Xiao Qian (2003).
** Private sector refers to the collection of rural and urban non-state and non-collective economic entities.
Sources: National Bureau of Statistics, *China Statistical Yearbook* (*Zhongguo Tongji Nianjian*) (Beijing: China Statistics Press), various years; data from China International Capital Corporation Limited (CICC).

criterion for measuring the success of reform. In his view, there are two pure strategies for transitioning to a market economy: Strategy A, organic development, which emphasizes a healthy development of the private sector; and Strategy B, accelerated privatization (see Table 3.5). According to Kornai, the experience of the transitional economies showed that Strategy A, which promotes growth of the private sector, has been the right one, with empirical support from Hungary and Poland. Strategy B, which suggests a rapid privatization of the SOEs is, at best, second best, and with potential harm if not well managed. The evidence came from the Russian experience.

With a slight modification, Kornai's framework could be applicable to the analysis of the Chinese reform from planned to market economy in terms of promoting private sector growth or focusing on privatizing the SOEs.

China's political system is different from the former Soviet Union and the Eastern European countries and the shift to market-oriented reform was led top down by the CCP. The strategy China took has been Strategy A rather than Strategy B, to the extent that the emphasis was put on the healthy growth of the private sector rather than rapid privatization of the SOEs in the early years of reform. The Chinese evidence also suggested that Strategy A has advantages over Strategy B. As I wrote in the preface of *Economic Reforms in Contemporary China* (2004), Strategy A has been an effective choice because it could promote capital accumulation and

Table 3.5 Main characteristics of the two transformation strategies

Strategy A – organic development	Strategy B – accelerated privatization
(i) The most important task is to create favourable conditions for bottom-up development of the private sector;	(i) The most important task is to eliminate state ownership as fast as possible;
(ii) Most of the companies hitherto in state ownership will have to be privatized, and the basic technique for doing so is sale;	(ii) The main technique for privatization is some form of give-away; for instance, a voucher scheme;
(iii) Any give-away distribution of state property must be avoided;	(iii) Dispersed ownership may actually be preferred;
(iv) Preference must be given to sales schemes that produce an ownership structure with a dominant owner;	(iv) Emphasis is not given to bottom-up development of private enterprises;
(v) The budget constraints on companies have to be hardened to ensure the financial discipline essential to operating in a market economy.	(v) It is expected that privatization will automatically harden budget constraints.

Source: Kornai (1999).

development of the entrepreneurs and the market system. Without these achievements, Strategy B has been unable to increase efficiency and, if not managed well, could lead to disorder of the market monopolized by a small group of the oligarchy, with endless harmful risks.[16] These characteristics are summarized in Table 3.5 above.

Existing economic and social problems

Despite the great achievements in China during the past 25 years, there are still a number of serious economic and social problems to be solved. Understanding and finding proper solutions for the problems determine the direction of the reform and development of the country.

Underdevelopment of the private sector and the increasing regional differences

As stated earlier, China's unique reform strategy – that is, developing the private sector from the grass roots – has been the key to its success. With this strategy, private business entered into the major part of the market, in some areas of which it even took a dominant position. However, this strategy is facing some difficulties, which increasingly restrain economic reform and development in China.

First, private business has been restricted from entry into the production factor sectors, which have been perceived as the 'critical sectors of the national economy' and have been controlled by the government. In some key sectors such as finance, telecoms, and oil, state-owned enterprises are the major players. The market is put under strict government control. The structure of the market remains completely monopolized or functions under monopolistic competition due to a lack of competition from the private sector. It creates monopolistic rents that, in turn, become a considerable incentive for the state-owned enterprises to refuse deregulation of entry restrictions by the government.

Second, a problem that should not be neglected, is that development of the private sector and market in the regions has been different in the past twenty-five years, which led to regional gaps in terms of development levels. According to comparative research by the Institute of National Economy, the degree of market development in various provinces has been not the same. The eastern coastal regions enjoy a higher level of development than the western provinces. In the western provinces with less market development, the private sector gained little development. This has not only contained the economic growth in the west, but also widened the regional development gaps between regions.

Problematic corporate governance

After 1993, the focus on reform in large SOEs has been switched from decentralization and the sharing of rights to institutional innovation of the enterprises. After 1999 in particular, the corporatization of large SOEs has made a number of breakthroughs. Notwithstanding, many non-standard measures have been taken by the corporatized large SOEs as a result of operational problems in the process, and the legacy of the decentralization and sharing of rights previously accepted:

1. The state, as the dominant shareholder, keeps its control over the large companies. State shares take overwhelming prominence in the corporatized listed companies in order to retain state control and the controlling shares are usually exercised by the authorized investment institution. This leads to the directors from such authorized investment institutions taking up a major position on the board of directors in the listed companies, which therefore puts the listed company with

multi-share holders under the control of the single authorized investment institution. As the result, the listed company cannot operate in line with the market rules.

2. The Party and government departments intervene in the company's operation too much. Because the authorized investment institution operates following old rules, the Party and government departments are able to take advantage of 'loopholes' to intervene in the company's business. This is achieved by imposing some public administration function and the personal wills of the political leaders on the company. The outcome of this results in the company's decisions being divorced from market requirements and creates excuses for violating financial discipline in the company.
3. Insider control created by the appointment through administrative means: the Party and government departments not only determine the selection of directors, but also stretch their hands to the direct appointment of managerial personnel. Furthermore, it is now common that the major managerial persons in a listed company are also the directors from the authorized investment institutions. The directors representing shareholders are intended to execute monitory rule on management in the circumstances of a separated ownership and control. But the current arrangement results in a self-monitoring, which make insider control unavoidable.

Widespread corruption

As a result of ubiquitous administrative interference, there are wide-ranging rent-seeking activities, and immense illegal wealth has been created.

1. Criminal officials and SOE managers' stealing of the public assets in the process of 'spontaneous privatization' has been growing rapidly. In the transformation of SOEs, inside managers sold the state assets to themselves with the aid of various methods (including management buy-outs) because of the serious insider control previously mentioned. This resulted in a huge transfer of the state assets to private hands. The key here is that transparent and fair rules for the transfer of property rights are lacking.
2. The 'robber barons' manipulated the less developed stock market through price or insider trading to make themselves millionaires. Because a stock market is featured with a typical asymmetry of information, people with a background of power or insider information, together with insiders in a listed company or financial institution, can

typically gain a high income through false statements, insider trading and manipulation. This is prevalent in China.

It is no exaggeration to say that China is facing the danger of moving towards crony capitalism or robber baron capitalism.

Incompetent legal system

The Party's 15th Congress in 1997 has made it very clear that China will move towards a society with the rule of law. However, there has been very little progress in recent years. The two most basic ingredients of the rule of law – legal transparency and consistency of enforcement – are not there yet.

1. The lack of transparency of China's legal system can be found in the following aspects:
   (a) There is insufficient participation in legislation by the citizens;
   (b) Many laws are not made known to the public after having been legislated;
   (c) Absence of legal predictability in citizens' behaviour.
   Many officials perceive laws as the tools by which to realize their own wills. Government departments like to take 'strict punishing measures' on the 'illegal behaviours' through their unlimited discretion. This has led to many unfair results and enhances rent-seeking activities.
2. The judiciary system lacks independence, and the so-called *Neibu Zhengce* ('internal policies') and *guanxi* ('personal connections') play an important role in the legal process. At the moment, another important threat to judiciary justice and independence comes from 'judiciary localization': that is, in the process of dealing with cross-regional economic disputes, the court usually adopts a favourable stance towards local parties. Furthermore, the Party departments at various levels are inclined to intervene or even determine the result of a trial.

Conclusion

In summary, China has been experiencing reform following the path of market socialism for over a half century, decentralizing the autonomous rights to the enterprises, increasing their rights under market regulation. However, none of these efforts has achieved the anticipated success.

Reform moved onto the right track in the 1980s after the course of incremental reform strategy was taken. This strategy is similar to what Kornai called 'Strategy A' (organic strategy), which emphasizes creating the environment for a grassroots growth of the private sector rather than increasing the autonomous rights of the SOEs. This has been the key for the success of Chinese economic development. With such an arrangement, China's reform broke with Soviet doctrine and the worship of state ownership. It gradually established a pattern of a multi-ownership economy, from which point it has moved along a path of comprehensive transition to a fully-fledged market economy. There are still many problems to solve, but the future is promising provided the country is following the right track.

Notes

1. W. Brus (1987) 'Market Socialism', in *The New Palgrave: A Dictionary of Economics*, John Eatwell (ed.), with Murray Milgate and Peter Newman (London and New York: Macmillan and Stockton).
2. Enrico Barone (1908) 'The Ministry of Production in the Collective State', in F.A. Hayek (ed.) (1935) *Collectivist Economic Planning* (London: Routledge & Kegan Paul): 245–90.
3. See W. Brus (1975) *Socialist Ownership and Political System* (London: Routledge & Kegan Paul).
4. W. Brus and K. Laski (1989) 'Preface', in *From Marx to the Market: Socialism in Search of an Economic System*, (Oxford: Oxford University Press).
5. *Ibid.*: ch. 10: 132–49.
6. *Ibid.*: 146.
7. W. Brus (1998) 'Preface' of Chinese edition of W. Brus and K. Laski (1989) *From Marx to the Market: Socialism in Search of an Economic System*, Chinese edn (Beijing: Shanghai Sanlian).
8. Sun Yefang (1956) 'Base the Planning and Statistics on the Law of Value', *Selected Works of Sun Yefang* [*Sun Yefang Xuanji*] (Taiyuan: Shanxi People's Publishing House): 117–46.
9. Sun Yefang (1984) 'On Issues of Financial and Economic System Within the Sector of the Ownership by the Whole People [*Guanyu Quanmin Suoyouzhi Jingji Neibu De Caijing Tizhi Wenti*] (1961)', *Selected Works of Sun Yefang* [*Sun Yefang Xuanji*] (Taiyuan: Shanxi People's Publishing House): 367.
10. Sun Yefang (1984) 'On Issues of Financial and Economic System Within the Sector of the Ownership by the Whole People [*Guanyu Quanmin Suoyouzhi Jingji Neibu De Caijing Tizhi Wenti*] (1961)', *Selected Works of Sun Yefang* [*Sun Yefang Xuanji*] (Taiyuan: Shanxi People's Publishing House): 242–6, 286–7.
11. Li Xiannian (1989) *Selected Works of Li Xiannian* (*Li Xiannian Wenxuan*) (Beijing: People's Publishing House): p. 330.
12. 'Communique of the Third Plenary Session of the 11th CCCPC [*Zhongguo Gongchandang Di Shiyi Jie Zhongyang Weiyuanhui Di San Ci Quanti Huiyi Gongbao*] (December 22, 1978)', (1982) Party Literature Research Centre,

CCCPC (ed.), *Selected Works of Major Literatures Since the Third Plenary Session [Sanzhong Quanhui Yilai Zhongyao Wenjian Xuanbian]* (Beijing: People's Publishing House).

13. The People's commune was based on three layers of ownership; that is, commune, big brigade and brigade, with the brigade as the basic unit.
14. See Masahiko Aoki and Masahiro Okuno (eds) (1996) *Comparative Institutional Analysis: A New Approach to Economic System* (Tokyo: University of Tokyo Press).
15. Jiang Zemin (1997) *Holding Highly the Grand Banner of Dengxiaoping Theory, Pushing Wholly the Constructing Undertaking with Chinese Characteristics to 21st Century – the Report at CPC 15th Congress [Gaoju Dengxiaoping Lilun Weidaqizhi, Ba Jiashe You Zhonguo Tese Shehui Zhuyi Shiye Quanmian Tuixiang Ershiyi Shiji]* (Beijing: People's Publishing House).
16. Wu Jinglian (2004) *Economic Reforms in Contemporary China [Dangdai Zhongguo Jingji Gaige]* (Shanghai: Shanghai Far-East Press).

References

Aoki, Masahiko and Okuno, M. (eds) (1996) *Comparative Institutional Analysis: A New Approach to Economic System* (Tokyo: University of Tokyo Press).

Barone, Enrico (1908) 'The Ministry of Production in the Collective State', in F.A. Hayek (ed.) (1935) *Collectivist Economic Planning* (London: Routledge & Kegan Paul): 245–90.

Brus, Wlodzimierz (1975) *Socialist Ownership and Political System* (London: Routledge & Kegan Paul).

Brus, Wlodzimierz (1987) 'Market Socialism', *The New Palgrave: A Dictionary of Economics*, ed. John Eatwell, Murray Milgate and Peter Newman, 4 vols (London and New York: Macmillan and Stockton).

Brus, W. and Lasky, K. (1989) *From Marx to the Market Socialism in Search of an Economic System* (Oxford: Oxford University Press).

CPC (1978) *Communique of the Third Plenary Session of the 11th CCCPC [Zhongguo Gongchandang Di Shiyi Jie Zhongyang Weiyuanhui Di San Ci Quanti Huiyi Gongbao]* (22 December 1978),' Party Literature Research Centre, CCCPC (ed.) *Selected Works of Major Literatures Since the Third Plenary Session* [Sanzhong Quanhui Yilai Zhongyao Wenxian Xuanbian] (Beijing: People's Publishing House, 1982).

CPC (1984) *The Decision on Economic System Reform [Zhonggong Zhangyang Guanyu Jingji Tizhi Gaige De Jueding]* (Beijing: People's Publishing House).

CPC (1993) *The Decision on Issues Regarding the Establishment of a Socialist Market Economic System [Zhonggong Zhongyang Guanyu Jianli Shehui Zhuyi Shichang Jingji Tizhi Ruogan Wenti De Jueding]* (Beijing: People's Publishing House).

Jiang, Zemin (1997) *Holding Highly the Grand Banner of Dengxiaoping Theory, Pushing Wholly the Constructing Undertaking with Chinese Characteristics to 21st Century – the Report at CPC 15th Congress [Gaoju Dengxiaoping Lilun Weidaqizhi, Ba Jiashe You Zhonguo Tese Shehui Zhuyi Shiye Quanmian Tuixiang Ershiyi Shiji]* (Beijing: People's Publishing House).

Kornai, J. (1990) *The Road to a Free Economy: Shifting from a Socialist System, the Example of Hungary* (New York: Norton).

Kornai, J. (1999) 'Ten Years After "The Road to a Free Economy": The Author's Self-Evaluation', paper for the World Bank Annual Bank Conference on Development Economy, 18–20 April 2000 (Washington, DC: World Bank).

Kornai, J. (2000) 'The Years after The Road to a Free Economy: The Author's Self-evaluation', Paper for the World Bank Annual Bank Conference on Development Economy, 18–20 April 2000,Washington, DC.

Li, Xiannian (1989) *Selected Works of Li Xiannian* (*Li Xiannian Wenxuan*) (Beijing: People's Publishing House)

Lange, O. (1936–37) ' On the Economic Theory of Socialism', in O. Lange and F. Taylor (1948), *On the Economic Theory of Socialism*, B. Lippincott (ed.) (Place: Minneapolis: University of Minnesota Press).

National Bureau of Statistics (various years) *China Statistical Yearbook* (*Zhongguo Tongji Nianjian*) (Beijing: China Statistics Press).

Sun, Yefang (1956) 'Base the Planning and Statistics on the Law of Value', *Selected Works of Sun Yefang* [*Sun Yefang Xuanji*] (Taiyuan: Shanxi People's Publishing House): 117–46.

Sun, Yefang (1984) 'On Issues of Financial and Economic System Within Economy of the Ownership by the Whole People [*Guanyu Quanmin Suoyouzhi Jingji Neibu De Caijing Tizhi Wenti*]', *Selected Works of Sun Yefang* [*Sun Yefang Xuanji*] (Taiyuan: Shanxi People's Publishing House, 1961).

Sun, Yefang (1984): *Selected Works of Sun Yefang* [*Sun Yefang Xuanji*]] (Taiyuan: Shanxi People's Publishing House, 1961).

Wu, Jinglian (2004) *Economic Reforms in Contemporary China* [*Dangdai Zhongguo Jingji Gaige*] (Shanghai: Shanghai Far-East Press).

Xu, Xiaonian and Xiao, Qian (2003) 'Another New Economy (*Ling Yi Zhong Xinjingji*)', Report of the Research Department of International Finance (China) Ltd (*Zhongguo Guoji Jinrong Youxian Gongsi Yanjiubu Baogao*).

4

China's Encounter with Market Socialism: Approaching Managed Capitalism by Indirect Means*

Louis Putterman

Introduction

In this chapter, I shall argue that although the Chinese Communist Party officially adopted the phrase 'socialist market economy' (*shehuizhuyi shichang jingji*) to describe China's economic model in 1993, China had actually completed its closest rendezvous with 'market socialism' by that year and was taking off in the direction of a predominantly capitalist economy. The years since 1992 have seen China deepen not market socialism but, instead, a managed market capitalism with only dwindling remnants of the socialist past.

For China's brush with market socialism, I propose the image of a 'fly-by', a close encounter on the path to a very different destination. A metaphor from space exploration might make the idea more vivid. In July 2004, the world was thrilled by images beamed back from the rings and moons of Saturn by the European-built, American-launched Cassini spacecraft. To put Cassini into orbit around Saturn, the US National Aeronautic and Space Administration (NASA) launched it atop a Titan IV rocket in October 1997 on a trajectory that, early on, included two 'gravity-assist' fly-bys of our 'sister' planet, Venus. I shall argue that China's fly-by of 'market socialism' was of a similar character: in order to put its once Soviet-style planned economy on a path toward a managed form of market capitalism[1] during an early reform period in which the Communist Party leadership still contained diverse elements that made socialism's gravity hard to escape, China's reformers first put the economy on what seemed to be a course towards planned socialism's sister economic system, 'market socialism'. Only later, with the help of the momentum gained during the market socialism fly-by, was the economy able to begin escaping socialism's pull more completely.

By 'market socialism', I mean a hypothetical economic system that adheres to two of the three core tenets in the orthodox conception of socialism to which the Communist parties of the Soviet Union and allied states once adhered; namely:

(a) state or social ownership of the means of production (factories, equipment, natural resources);
(b) incomes determined by work (that is, no private returns to non-labour factors of production, but rejection of the egalitarianism of 'distribution according to needs'); and
(c) coordination (which is required by any complex modern economy) provided primarily by planning on the basis of physical quantities.

By 'market socialism', I have in mind a system that retains elements (a) (social ownership) and (b) ('distribution according to work') from the above list, but which drops element (c) in favour of the use, or at least simulation, of markets.

The modifications of (c) sufficient to shift the system from conventional planned socialism to market socialism vary. One variant of 'market socialism' might continue to give considerable power to planners, who would still attempt to coordinate the economy, as in orthodox socialism, but who, instead of directing enterprise managers to carry out plans specified in physical terms, would direct managers to maximize profits – or to achieve some other criterion, such as Lange's MC = price condition – subject to administratively set prices. The planners' job, then, would be to set prices rather than quantities. In a far more 'planless' version of 'market socialism', state or social ownership (feature (a)) and earnings based on labour (feature (b)) would be retained, but market forces would be allowed to govern resource allocation, working through the normal paths of an unregulated price system. The academic model of market socialism proposed by Lange, Lerner, and Taylor lay in between these extremes, in that planners would have attempted to influence the economy on a large scale by determining (perhaps through setting different interest rates) how investment funds would be allocated among major sectors of the economy and perhaps certain priority goods, but would have left details on the combinations and varieties of final goods to be determined by ordinary market forces, with planners making no attempt to influence consumer goods prices.

How we think of market socialism has been muddied in practice by the presence of a quite different dimension of variation, that of the degree to which privately-owned enterprises are tolerated alongside publicly-owned enterprises. When an economy with a substantial state sector allows private enterprises a substantial role as well, it aids clarity, in my view, to call the resulting system a 'mixed economy' – that is, a mixture of socialist and capitalist systems – but not to use the term 'market socialism'. An example of a mixed economy with a prominent socialist element is Russia under the New Economic Policy of Lenin. The economies of China and Vietnam are clearly 'mixed' today.

For better or for worse, there have been no real-world examples of a market socialist economy in the pure sense. Every country that has experimented with a major dose of market socialism – most notably Yugoslavia from the mid-1950s to the late 1980s, Hungary between 1968 and 1989, and China from 1979 to the early 1990s – also introduced a mixed economy element, allowing private ownership of small enterprises.

Still, it serves clarity to keep the notions of 'mixed economy' and 'market socialism' distinct in our minds. An economy consisting entirely of state-owned enterprises that goes through a process of gradual privatization will exhibit different admixtures of private and publicly-owned enterprises along the way, with the proportion of enterprises that are privately-owned growing monotonically as the process proceeds (see the dashed line in Figure 4.1). This is not, however, market socialism. The latter has been conceived of as a destination in its own right – from which springs its fascination for the economic systems theorist. Figure 4.1 provides a visual representation of how the four systems – capitalism,

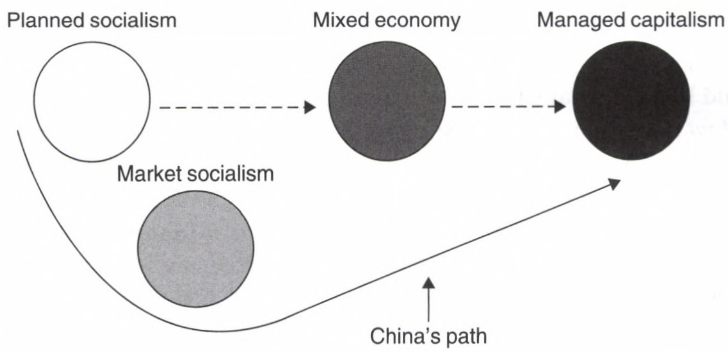


Figure 4.1 China's path towards managed capitalism

planned socialism, a mixture of capitalism and socialism, and market socialism – are related, according to the view that I have sketched. The solid line represents China's reform path which, while, even from the first, making the economy more mixed in character, swung close by a version of market socialism during the first reform decade rather than follow a more direct path to capitalism by way of a simple mixed economy.

China as a market socialist economy: the mid-1980s approach

In 1984, urban privately-owned enterprises accounted for little more than 1 per cent of China's industrial output. State-owned enterprises still accounted for 69 per cent of industrial output, urban collectively owned enterprises for another 18 per cent, and a large majority of that 12 per cent of industrial output that China's statistics associated with 'township and village enterprises' (TVEs) was still being produced by enterprises officially belonging to those two levels of rural local administration. Thanks to the de-collectivization process of 1979 to 1983, agricultural production was overwhelmingly in the hands of households, but farming was still a private–public hybrid in which land belonged to the rural collectives, the provision of most credit and other farm inputs was also by public entities, and the government still set crop targets and procured a substantial part of the harvest. Only in small-scale rural trade and transportation, rural construction, other rural sidelines, and urban petty trade was fully private enterprise prevalent. China's economy was showing some admixture of private enterprise by the mid-1980s, therefore, but a large part of its systemic change thus far – and this was so at least to the end of that decade – had been the introduction of market pricing and the profit motive to an economy of public ownership in which earnings were overwhelmingly attributable to labour. The case could be made that China was building a market socialist economy.

How might market socialism have functioned in China? Imagine that China, like Yugoslavia before it, had embraced a full-blown ideology of market socialism – the idea that social ownership of the means of production should be married to market coordination of economic activity. The buildings, equipment, and land used by industrial and other enterprises could have belonged to central, provincial, municipal, county, township and village governments, which would have retained the power to hire and fire their managers. Managers would have been expected not to meet physical plan targets but, rather, to make their enterprises profitable, and they would have been rewarded for achieving profitability by being able to pay themselves and their workers bonuses from some of those profits, and being able to expand their enterprises by investing the remainder. Other investment funding would have come not from government allocations but from bank loans and enterprise bonds. Market forces would have guided managers' decisions, but non-labour resources would have remained socially owned, so that incomes would be returns on labour contributions only. These conditions were in fact approximated in the mid- to late 1980s in the still large SOE, township, village, and urban collective sectors of China's economy.

China's leaders could have, and did, justify the system roughly as follows. 'Socialism' would continue to mean that individuals could not enrich themselves by extracting private returns from the society's scarce resources. A socialist society would reward the effort of the individual both as a matter of fairness and as a necessary incentive. Markets would be allowed to play a coordinating role because physical planning had proven too difficult to do in adequate detail, and top down control squelched initiative from below. The state would retain the power to intervene and steer the economy when and where markets failed, but it would otherwise leave them to do their job (Zhao Ziyang's formulation was 'the government controls the market and the market controls the economy'). Some state guidance with respect to the allocation of investment among broadly defined sectors would remain, as in the Lange–Lerner model but, by and large, the system would be more thoroughly market-driven than those economists appear to have had in mind.

China's rapid rate of economic growth between 1979 and 1992 makes it reasonable to argue that its experience in that period was the most impressive instance of market socialism ever observed. Indeed, many did argue from China's example that Western property rights fundamentalists had been proven wrong by China's example (Weitzman and Xu, 1994; Stiglitz, 1996; Ellerman and Stiglitz, 2001). Hungary's approach to market socialism had improved Hungarians' access to better food and more consumer goods, but had not distinguished Hungary's economic growth rate from those of more orthodox East European neighbours. Yugoslavia had its 'economic miracle' in the 1960s, but long before ethnic implosion made that country more famous for civil war than for economic growth, the lustre had already worn off due to chronic inflation and unemployment.

It is not clear how much of China's economic growth in the 1980s can be attributed to market socialism. TVEs surely displayed dynamism, suggesting that ownership by local government does not rule out entrepreneurial drive and productive efficiency (see Putterman, 1997, as well as Chang and Wang, 1994; Weitzman and Xu, 1994; and Che and Qian, 1998). SOEs also increased their efficiency when exposed to market forces and when invited to seek profits (Jefferson and Singh, 1999). But SOEs might not have experienced as much increase in productive efficiency had they been competing *only* with other SOEs and with collectively owned TVEs. Even in the 1980s, some dynamic rural enterprises were privately owned, others were private enterprises disguised as collectives, and, after 1992, private enterprises grew far more rapidly than public enterprises in both the rural and urban sectors, despite severe discrimination in access to bank financing. A dynamic small-scale private rural non-farm sector existed from 1978 onwards. Although one cannot rule out that China's economy might have achieved fairly impressive growth even if its market socialist components had been unaccompanied by a private enterprise sector, there is no way to prove this.

I judge China's experience in the 1980s as suggestive of the possibility that socially owned enterprises operating in a market environment might well form an effective core of a viable economy. However, China's experience also demonstrates that market socialism has little chance of long-run viability unless strong barriers to the growth of private enterprise are erected; for example, rules requiring that enterprises convert to cooperative or public ownership after achieving a certain scale. As barriers to large-scale private ownership fell by the wayside, it became inevitable that China would leave the orbit of market socialism and travel on towards a more capitalist-style economy.

Why was market socialism a way-station rather than a destination?

In this section, I wish to argue a simple thesis: that market socialism cannot survive unless legal, political, and social constraints prevent a transition to market capitalism. Because, during the 1980s, these constraints were present in China to a limited degree only, and because they were largely removed by the mid-1990s, China orbited market socialism only as a voyager on a path to a managed version of market capitalism.

China's market socialism was unstable for two reasons: one general, and one historically specific. The general reason is that the combination of natural human acquisitiveness or self-interest and natural human variability with respect to intelligence, drive, intensity of self-interest, and other characteristics, means that a market economy will fairly quickly become a capitalist economy unless there are policy or constitutional barriers to capitalist forms of property. The historically specific reason is that late-twentieth-century China was subject to powerful internal and external influences that made real commitment to market socialism extremely unlikely.

That most human beings are driven by a strong interest in the material wellbeing of themselves and their families is an idea at the heart of economics. Most humans also have socially reinforced yet naturally conditioned social preferences: desires to look good in the eyes of other people; tendencies to judge one another according to social criteria; receptivity toward pro-social value orientations including reciprocity, loyalty, trust; and the desire to punish those who opportunistically exploit pro-social rules (Rabin, 1998; Bowles, 2003). Different mixtures of self-interest and pro-social behaviour are observed at different times and exhibited by different individuals, but self-interest is part of the make-up of every individual, and strongly so for a great many.

It is equally clear that people vary over a wide range in terms of intelligence, mental and physical energy, willingness to bear risk, and other characteristics conducive to success in a market economy. In a relatively unconstrained market economy, the most intelligent, energetic, innovative, self-interested, risk-taking and fortunate individuals can earn far higher rewards than their less intelligent, energetic, innovative, self-interested, risk-taking and fortunate counterparts. Some quite intelligent, energetic, and innovative individuals might be more drawn to the pursuit of social approval and of intrinsic rewards from serving the good of a community or group than to the amassing of personal wealth. But when the magnitude of the rewards that can accrue to using their gifts self-interestedly is unconstrained and readily visible, most of a society's potential economic dynamos are attracted away from the disinterested service of others. In open competition, private enterprise grows at the expense of social at least partly because it concentrates more rewards in the hands of the more able and driven. Less driven or capable types who form the rank-and-file workforce of an industrial society will, in turn, accept employment in firms formed by for-profit entrepreneurs unless the cooperative and social sectors offer equal or better conditions of employment, which it is ever harder for them to do as talented leadership is drawn to the private sector (Putterman, 1982).

Capital is also drawn towards private enterprise. As wealth becomes differentiated and individuals begin to have resources to invest, entrepreneurial individuals who identify prospects for high returns will establish enterprises under their own control, rather than set up cooperatives, lend to banks, or buy the bonds of social sector enterprises. Cooperative and social enterprises can be financed in part by borrowing from banks and other intermediaries, but some internal finance is necessary in a market economy, because lenders become reluctant to lend or demand exorbitant rates of interest at very high debt/equity ratios. Undercapitalization of workers' cooperatives, attributable mainly to worker liquidity contraints and risk aversion, is widely observed (Bonin, Jones and Putterman, 1993; Pencavel, 2001; Dow, 2003). If property rights in worker-run firms are collective or social, as they were in Yugoslavia, this problem would be exacerbated unless banks were directed by the government to funnel credit into the sector, a phenomenon that fuelled inflation in that country (Pejovich, 1973; Bonin and Putterman, 1987). State-owned enterprises can have an advantage in accessing credit markets if the government is believed to guarantee repayment, but such guarantees also give rise to 'soft budget constraints' which make SOEs less efficient than private firms.

Apart from these general reasons why entrepreneurial talent and capital are drawn to private rather than social and cooperative enterprises in the absence of constraints, there were historical factors pointing China towards private enterprise in the 1980s and 1990s. The combined wealth of the overseas Chinese communities of Southeast Asia and elsewhere has been estimated to be of comparable magnitude to that of the Chinese state and citizenry. Overseas Chinese accounted for more than half of all direct foreign investment into China during the 1990s. The practice and ethos of capitalism animated the overseas Chinese community, be it in Hong Kong, Taiwan, Singapore, or further afield, and Chinese leaders eager to entice more investment could readily see that investment volumes would grow most rapidly if constraints on private ownership within China itself were relaxed.

Intellectual currents also militated against restricting China's way forward to a market socialist path. The concept of market socialism was on the agendas of only a handful of intellectuals, mainly in the West. In China as much as in the former Soviet Union and Eastern Europe, policy-makers and intellectuals anxious to see their country emulate the economic dynamism of Taiwan, South Korea, Singapore, Japan, and the West, were naturally averse to 'experiments' with some 'third way'. Reformers such as Zhao Ziyang were anxious to receive policy advice from overseas Chinese and Westerners. Students sent to study economics in the West with the memory of the Cultural Revolution still fresh in their minds were attracted to the already dominant and, in the early 1980s, increasingly influential free market approaches within Western academic economics. Many returned to China eagerly advocating a faster pace of reform.

The SOEs: service and demise

It is widely accepted that in most industries, state-owned enterprises tend to use resources less efficiently than those that are privately owned. But, conceivably, the efficiency difference between private and state-owned enterprises might be relatively small in an environment of market competition and budgetary discipline (Vickers and Yarrow, 1991). In this section, I argue that in the China of the 1980s and 1990s SOEs operated below their hypothetical efficiency potential due to the particulars of policy. In brief, the state used the SOEs as a vehicle for maintaining urban social stability while promoting rapid economic growth. Making the SOEs a cushion for reform contributed to the inevitability of their demise (Putterman, 1992; Dong and Putterman, 2000).

SOEs were the backbone of Chinese industry into the early 1990s, and output could not have grown as rapidly without their sustained production. But SOEs performed at least as important a function for China's leaders in the social and political domain: they were the backbone of urban social stability, supplying what grew to be more than a hundred million employees with stable wages and benefits. A test of the efficiency *potential* of state ownership in a market setting could not be carried out under such conditions.

Until the early 1990s, state employment was by far the best deal available to Chinese workers, and a deal that could never have been maintained in a competitive labour market. Econometric estimates suggest that a large majority of SOE workers were not overpaid relative to the value of their marginal products (Parker, 1999; Dong and Putterman, 2002). They were, however, paid more than their opportunity cost to the economy, implying that a market equilibrium would have seen both lower wages and more jobs (Zhuang, 1996).

In order to assure SOEs' abilities to maintain employment and benefits to workers even as state–state and state–non-state competition eroded SOE profits (Naughton, 1992), China's government kept SOE budgets soft and funnelled capital to them through a banking system still directed by the state. Although the government finally began to withdraw its financial largesse from the SOEs after 1992, it did not withdraw quickly enough its demand that they maintain employment, wages, funding of pensions, housing subsidies, and large tax payments (Dong and Putterman, 2002). The consequent financial losses made local governments anxious to transfer small and medium SOEs to private owners.

Returning to Figure 4.1, the somewhat more autonomous, more profit-oriented SOEs of the 1980s can be conceived of as major components of the 'market socialism' with which China's economy rendezvoused on its way to a more radically reformed economy. But, in retrospect, they might also be visualized as one of the engines of the rocket that propelled China out of the orbit of both socialisms. Having spent their fuel to maintain urban social stability and to keep production on a course of steady growth, most of the SOEs were jettisoned from the social sector in the late 1990s as China's economy sped onward towards its destination, a market economy composed mainly of privately owned enterprises.

Can market socialism work: what evidence from China?

How might a market socialist system have performed in China if the SOEs had *not* been kept on 'life support' to fulfil social and political functions, if banks had been allowed to make loans according to financial criteria only, and if the government had maintained a strict policy of barring the existence of large-scale firms having mainly private ownership? China's experience seems to provide evidence of the potential adequacy, if not optimality, of local public ownership in a market environment. I have argued elsewhere that large numbers of township and village cadres responded to the disequilibrium opportunities existing in China at the end of the 1970s in genuinely entrepreneurial fashion (Putterman, 1997; see also Walder, 1994). Many studies found SOEs to be increasing their technical efficiency under the influence of profit retention incentives, increased managerial autonomy, and manager contract systems (Rawski, 1994; Groves *et al.*, 1994, 1995; Jefferson and Singh, 1999).

Were these only marginal improvements, possible only for as long as China was taking its first steps away from the still less efficient system of public ownership without markets? Not necessarily. China's experience offers support for the argument that the competitiveness of the environment is as important as who owns the firm. One cannot rule out that efficiency would have increased further had China proceeded to harden budget constraints and make banking, too, a market driven sector, while inviting into its markets only the smallest, fully private firms and requiring large firms to operate under forms of collective or local public ownership. Property rights could have been further 'clarified', as the phrase went, without assigning them to individuals. For example, township enterprises could have become genuinely collective by increasing the effectiveness of local democratic control over township governments and requiring those governments to compensate residents for their contributions to collective capital accumulation if they moved to a city. SOEs could have transitioned to a shareholding system in which various public entities, including municipal and provincial governments and publicly owned banks and insurance companies, owned clear numbers of shares, and had proportionate control in electing board members. Under ideal conditions, these owners might have demanded a focus on value maximization from the board members whom they elected.[2]

The ideological and cultural environment was probably wrong in a China still emerging from pre-reform excesses, under a government with no history of democracy, and at an historical juncture at which the desire to overcome poverty and catch up with more advanced economies took precedence over everything else (except perhaps the Party's continued rule, not a conflicting goal in the short to medium run in any case). In the final analysis, to be sure, there may well be limits to the strengthening of entrepreneurial and managerial incentives when collectivities of citizens are the ultimate principals in the agency relationships central to a modern financial system.[3] But future citizens of more prosperous societies who, for whatever reason, might wish to limit private ownership of productive resources while preserving the beneficial qualities of market competition, need see nothing in China's experience to demonstrate that such a system cannot work tolerably well.

Why has China's economy grown so rapidly?

If a successful experiment with market socialism is not the main explanation for China's rapid growth since 1979, what is? For some economists, the explanation for China's rapid growth lies in liberalization and opening-up quite generally, including the creation of a space for private enterprises. But surely liberalization by itself is not enough to explain China's success? Most of the countries of sub-Saharan Africa, Latin America, and the Middle East never had centrally planned economies, and most have been reducing state ownership of industry, government marketing monopolies, tariffs, and overvalued exchange rates since the mid-1980s. Yet, almost none can match China's record of economic growth in the past 25 years.

I suggest that liberalization is one of *four* main engines that have boosted China's economy onto its high growth path. The other three, all of roughly equal importance, are:

(a) the proximity and the blood and cultural ties of many of the other high growth economies of the world;
(b) the strong societal capabilities inherited from centuries of civilization, an inheritance partly shared with those neighbours;
(c) favourable adjustments made to China's pre-1949 'initial conditions' during the 30 years *before* market-oriented reform.

Most readers will be familiar with factor (a); I wish to concentrate my discussion on factors (c) and (b), which are less commonly considered.

A key finding of the economic growth literature of the past 15 years has been that poorer countries grow faster than richer ones, as predicted by economic theory, only after controlling for certain institutional and other factors. But which factors are the most important to control for? A good way to introduce the factors I wish to emphasize is to cite Moses Abromovitz's remark that 'a country's potential for rapid growth is strong not when it is backward without qualification, but rather when it is technologically backward but socially advanced' (Abramovitz, 1986).

In a series of papers, various co-authors and I have argued that an empirically important determinant of the societal capacity for modern growth is the timing of the transition from the pre-agricultural band to the agrarian state form of social organization, and the subsequent progress of development prior to the era of modern industry. The transition to agriculture took place at very different points over the past 4,000 years in different parts of the world, with Eurasian societies around the Mediterranean, the Near East, South Asia and China completing it earlier than most of sub-Saharan Africa, the Americas, and Oceania. Regions also differed in their subsequent histories, with parts of Northern Europe emerging as centres of civilization toward the end of the Medieval era, lands with small or decimated aboriginal populations such as the USA and Australia giving rise to transplanted Northern European societies after 1600, and areas such as Egypt, Persia and India manifesting relative stagnation or retrogression as modern times approached.

Burkett, Humblet and Putterman (1999); Bockstette, Chanda and Putterman (2002); and Chanda and Putterman (2006) estimated cross-country regression models explaining the rate of growth of per capita output from 1960 to 2000 as a function of initial income, investment, education, population growth rate, and assorted indicators of pre-industrial development. These indicators – population density in 1500 and 1960, cultivated land per farmer, the share of agricultural land irrigated, an index of government above the level of the tribe covering the years 1 to 1500 or 1 to 1950 CE, and the estimated date of the transition to agriculture from food gathering and hunting – were all found to be good predictors of the late twentieth-century rate of economic growth. For non-European countries, the rate of growth between 1500 and 1960 – the era of European colonialism – was *inversely* related to early development (Acemoglu, Johnson and Robinson, 2002; Chanda and Putterman, 2006). But once European colonial domination receded in the postwar era, countries that had had an earlier start on technological, economic and social development again grew more rapidly, so that by the end of the second millennium, early starters (those that made the transition to agriculture and the state earlier) were once again in the lead in terms of per capita income (Hibbs and Olsson, 2004) and especially rate of economic growth (Chanda and Putterman, 2006).[4]

The application to China is straightforward. Existing research suggests that agriculture began in China by or before 7,000 BCE, possibly the earliest of the independent appearances of crop production outside the Fertile Crescent.[5] From that time to the beginning of the Common Era, China went through a classic progression from crop cultivation to formation of settled villages, to development of writing and metallurgy, and growth of the first small and eventually large-scale states. Over the centuries, the successful Yellow River civilization spread to absorb or push aside the numerous non-Han ethnic groups inhabiting the vast expanses to that river's south, also influencing the development of civilizations in Korea, Japan, and Southeast Asia. By the time that Europeans such as Marco Polo made contact with China in the thirteenth century, the country was arguably the most advanced in the world in terms of agricultural and other scientific techniques, use of currency, printing, and complexity of urban life; and it was among the world's leaders in knowledge of astronomy and mathematics. China was a pioneer in establishing principles of public administration including a system of meritocratic recruitment of officials based on tests of literary knowledge. In Marco Polo's day, by contrast, many peoples of the Americas, sub-Saharan Africa, Australia, New Guinea, the Philippines, and Oceania, had no written language, no government above the level of the tribe, no man-made currency, no use of ploughs and draught animals (Diamond, 1998).

Although China did not become a European colony after 1500, it did experience a 'reversal of fortune' much like those of the other densely populated, relatively urbanized non-European societies studied by Acemoglu, Johnson and Robinson (2002). But like other such countries, including South Korea, Malaysia, Thailand, and most recently

India, China has experienced relatively rapid economic growth in recent decades.

From the 1950s until recent years, China also enjoyed relatively modest levels of inequality and of conflict among socioeconomic classes, factors that were associated with retarded growth in much of Latin America. The hacienda and plantation systems associated with economic inequality in that region and in the Philippines never existed in China, and much of the economic inequality that existed among Chinese prior to 1949 was suppressed until the 1980s by the policies of China's Communist government. China enjoyed a modicum of social stability and a government interested in broad-based economic development rather than in protecting the position of a small property-owning class.

Other aspects of China's experience from the 1950s to the 1980s contributed to rapid growth in the reform era. While it is common to see statements to the effect that the first 30 years of Communist rule in China were nothing but an economic and human disaster, such statements are inconsistent with the actual record. One may justify a negative view of the CCP, at whose doorstep lies the blame for the massive Great Leap famine, the persecution of those with the 'wrong' class background or political leanings, and the repression of intellectuals and free thought. And one may be critical of the heavy industry-centred industrialization strategy of the Mao era. Yet, during the first decades of Communist rule, China's rate of capital formation was raised from below 10 to over 25 per cent of GDP, the foundations of many industries were established, basic sanitation, access to health care, and primary education were expanded, and a century or more of net stagnation of per capita income gave way to modest growth. Along the way, China accrued some assets that bore still more fruit after the start of market-oriented reforms.

However lopsided China's industrialization strategy was, it did put in place capacities for producing steel, chemicals, and machinery that could continue to be built upon in the reform era. While China was establishing producer goods industries in the pre-reform decades, most other developing countries were trying to foster industrialization by substituting home production for imported light manufactures, a strategy (known as import substitute industrialization) that usually left them indebted and dependent on capital goods from abroad. The sustaining of investment at levels of more than 25 per cent of GDP in virtually every year since the mid-1950s was originally, at least, a centrepiece of China's forced-draught industrialization strategy, and undoubtedly one of the lynchpins of China's growth.[6] Advances in the basic education status of China's population, however much higher education and free thought were neglected or suppressed, made easier the subsequent training of large numbers of Chinese in both applied and scientific fields. And for all the political instabilities of the first 30 years of Communist rule, China built up administrative capabilities that, in the reform era, gave it an efficacy matched by only a few 'developmental states'. China's anti-natalist policies helped to check population growth and to raise the rate of growth of per capita income. And China's government was arguably the most successful in the Communist and ex-Communist worlds in managing a transition to a market economy without a major decline in incomes and with only modest levels of inflation.

China's fast growing rural industry is an example of a leading sector in the reform era that owed much of its existence to pre-reform era policies. The early township and village enterprises were continuations of commune and brigade enterprises whose output value had already been growing at a rate of almost 26 per cent a year between 1970 and 1976 (Byrd and Lin, 1990). The commune system gave commune and brigade leaderships in better-positioned localities the ability to direct into industrial investment substantial amounts of capital that would most likely have ended up in some combination of consumption and petty enterprise had it been paid out to households. The very imbalance of China's pre-reform economy, with the disproportionate utilization of capital in large-scale heavy industry and the relative neglect of consumer goods, meant that in the 1980s there were large unfilled niches that rural industries could fill, whether as independent producers, as subcontractors to state enterprises, or as partners of foreign firms wanting to carry out labour-intensive production for export (Putterman, 1997).

Conclusion

During the first decade-and-a-half of market oriented reforms, China's economy was simultaneously becoming more market socialist in character but also more of a mixed economy, with an increasing role for private ownership. By the mid-1990s, China was leaving its rendezvous with market socialism behind as it headed onwards towards a more fully capitalist economy, albeit one with a heavy dose of state management and lingering vestiges of previous institutions. Some remnants of market socialism, including what remains of the state sector and considerable state ownership of former SOEs converted to shareholding firms, are still present in 2005, but change continues and its direction is clear.

What lessons about market socialism can be extracted from the Chinese experience? China's encounter with market socialism was severely compromised by the role assigned to the state sector as a social and political buffer for reform. Even so, forms of public ownership showed considerable dynamism during China's first 15 years of market-oriented reforms. The Chinese experience suggests that market socialism cannot be established as a lasting institutional framework without legal and constitutional constraints. How well market socialism might perform under the best of circumstances remains a matter of conjecture, but China's experience falls short of demonstrating such a system's impossibility.

A few enthusiasts of the market socialist concept have looked to China's impressive economic growth during the period in which it approximated such a system most closely for evidence of its efficacy. But much of China's growth since 1979 is attributable to the private side of an increasingly mixed economy, and other key factors explaining China's growth since 1979 are independent of the particular institutions of the post-1979 period. Importantly, China has exemplified Abramovitz's assertion that a lagging economy is most likely to catch up when it has strong social capabilities to draw upon. While investments in physical, human, and organizational capital in the Mao era have also played their parts, a large part of the reason why China has grown more rapidly than Congo, New Guinea, Nicaragua, or many other poor countries, can be found in factors that differentiated their respective societies well over a century before Deng Xiaoping set free his famous black cat.

Notes

* I am grateful for the comments of participants in the IEA Round Table on Market Socialism in China, and especially those of my discussant, Carsten Holz.

1. By 'managed capitalism' I mean an economic system, such as that of postwar Japan, in which the means of production are mostly privately owned, the preponderance of economic coordination is by market forces, and government attempts to guide the economy using discretionary taxes, interventions in credit markets, and other tools.
2. Whether public owners can be effective monitors of firm performance is an open question. In a careful study of US corporate governance, Qiu (2003) found that public pension funds such as California's CALPERS seemed, in fact, to be more effective than any other group of shareholders in preventing firms whose shares they owned from engaging in value-reducing merger and acquisition activity. There is a small literature on public ownership in market socialism touching on governance issues, including Bardhan and Roemer (1993) and Wright (1996).

3. In Putterman (1993), I argue that public owners are unlikely to match the efficiency of private owners as long as polities are large, because the financial system then consists of principal–agent relationships in which the ultimate principal is a citizenry whose individual members have strong incentives to freeride.
4. Somewhat parallel to these findings is Temple and Johnson's (1998) discovery that developing countries with higher indices of modernization as of the early 1960s achieved higher rates of economic growth during 1960 to 1985.
5. Agriculture is thought to have reached Egypt, Europe, and possibly Persia and India, from the Fertile Crescent, while its independent origins in the New World were considerably later than those in China.
6. Note the large literature beginning with Alwyn Young (1995), who found that high rates of formation of capital, rather than high rates of technological change, bear most of the responsibility for high growth in east Asia.

References

Abramovitz, Moses (1986) 'Catching Up, Forging Ahead, and Falling Behind', *Journal of Economic History*, 46: 385–406.

Acemoglu, Daron; Johnson, Simon and Robinson, James (2002) 'Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution', *Quarterly Journal of Economics*, November, 1231–94.

Bardhan, Pranab and Roemer, John E. (eds) (1993) *Market Socialism: The Current Debate* (New York: Oxford University Press).

Bockstette, Valerie; Chanda, Areendam and Putterman, Louis (2002) 'States and Markets: The Advantage of an Early Start', *Journal of Economic Growth*, 7: 347–69.

Bonin, John P. and Putterman, Louis (1987) 'Economics of Cooperation and the Labor-Managed Economy', *Fundamentals of Pure and Applied Economics*, 14, March (London: Harwood Academic Publishers).

Bonin, John P.; Jones, Derek and Putterman, Louis (1993) 'Theoretical and Empirical Research on Producers' Cooperatives: Will Ever the Twain Meet?', *Journal of Economic Literature*, 31: 1290–320.

Bowles, Samuel (2003) *Microeconomics: Behavior, Institutions, and Evolution* (Princeton: Princeton University Press).

Burkett, John P.; Humblet, Catherine and Putterman, Louis (1999) 'Pre-Industrial and Post-War Economic Development: Is There a Link?', *Economic Development and Cultural Change*, 47(3): 471–95.

Byrd, William and Qinsong, Lin (1990) *China's Rural Industry: Structure, Development and Reform* (New York: Oxford University Press).

Chanda, Areendam and Putterman, Louis (2006) 'Early Starts, Reversals and Catch-up in The Process of Economic Development', *Scandinavian Journal of Economics*, 109(2): 387–413.

Chang, Chun and Yijiang Wang (1994) 'The Nature of the Township-Village Enterprise', *Journal of Comparative Economics*, 19: 434–52.

Che, Jiahua and Qian, Yingyi (1998) 'Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises', *Journal of Law, Economics and Organization*, 14(1): 1–23.

Diamond, Jared (1998) *Guns, Germs and Steel: The Fates of Human Societies* (New York: Norton).

Dong, Xiao-Yuan and Putterman, Louis (2000) 'China's SOE's: Their Role, Job Creation, and Efficiency in Long-Term Perspective', *Modern China*, 26: 403–47.

Dong, Xiao-Yuan and Putterman, Louis (2002) 'China's State-Owned Enterprises in the First Reform Decade: An Analysis of a Declining Monopsony', *Economics of Planning*, 35(2): 109–40.

Dow, Gregory (2003) *Governing the Firm: Workers' Control in Theory and Practice* (New York: Cambridge University Press).

Ellerman, David and Stiglitz, Joseph (2001) 'Not Poles Apart: "Whither Reform?" and "Whence Reform?"', *Journal of Policy Reform*, 4(4): 325–38.

Groves, Theodore; Yongmiao, Hong; McMillan, John and Naughton, Barry (1994) 'Autonomy and Incentives in Chinese State Enterprises', *Quarterly Journal of Economics*, 109: 183–209.

Groves, Theodore; Yongmiao, Hong; McMillan, John and Naughton, Barry (1995) 'China's Evolving Managerial Labor Market', *Journal of Political Economy*, 103(4): 973–92.

Hibbs, Douglas A. and Olsson, Ola (2004) 'Geography, Biogeography, and Why Some Countries are Rich and Others are Poor', *Proceedings of the National Academy of Sciences*, 101: 3715–20.

Jefferson, Gary and Singh, Inderjit (eds) (1999) *Enterprise Reform in China: Ownership, Transition, and Performance* (New York: Published for the World Bank by Oxford University Press).

Kornai, János (1986) 'The Soft Budget Constraint', *Kyklos*, 39(1): 3–30.

Maddison, Angus (1991) *Dynamic Forces in Capitalist Development: a Long-run Comparative View* (New York: Oxford University Press).

Naughton, Barry (1992) 'Implications of State Monopoly over Industry and Its Relaxation', *Modern China*, 18(l): 14–41.

Parker, Elliott (1999) 'Are Wage Increases in Chinese State Industry Efficient? A Study of Productive Efficiency in the Nanjing Machine-Building Industry', *Contemporary Economic Policy*, 17(1): 55–68.

Pejovich, Svetozar (1973) 'The Banking System and the Investment Behavior of the Yugoslav Firm', in Bornstein, Morris (ed.) *Plan and Market: Economic Reform in Eastern Europe* (New Haven: Yale University Press).

Pencavel, John (2001) *Worker Participation: Lessons from the Worker Co-ops of the Pacific Northwest* (New York: Russell Sage Foundation).

Putterman, Louis (1982) 'Some Behavioral Perspectives on the Dominance of Hierarchical over Democratic Forms of Enterprise', *Journal of Economic Behavior and Organization*, 3: 139–60.

Putterman, Louis (1992) 'Dualism and Reform in China', *Economic Development and Cultural Change*, 40: 467–93.

Putterman, Louis (1993) 'Exit, Voice, and Portfolio Choice: Agency and Public Ownership', *Economics and Politics*, 5: 205–18.

Putterman, Louis (1997) 'On the Past and Future of China's Township and Village Owned Enterprises', *World Development*, 25: 1639–55 (Chinese version: 220–53, in Wen Hai (ed.), *Chinese Township Village Enterprises: Nature, Experience and Reforms* (Beijing: China Industry and Commerce Association Press).

Qiu, Lily (2003) 'Which Institutional Investors Monitor? Evidence from Acquisition Activity', Yale International Center for Finance Working Paper 04-15, December.

Rabin, Matthew (1998) 'Psychology and Economics', *Journal of Economic Literature*, 36(1): 11–46.

Rawski, Thomas (1994) 'Progress without Privatization: The Reform of China's State Industries', in Milor, Vedat (ed.), *Changing Political Economies: Privatization in Post-Communist and Reforming Communist States* (Boulder, CO: Lynne Rienner): 27–52.

Stiglitz, Joseph (1996) *Whither Socialism?* (Cambridge, MA: MIT Press).

Temple, Jonathan and Johnson, Paul A. (1998) 'Social Capability and Economic Growth', *Quarterly Journal of Economics*, 113(3): 965–90.

Vickers, John and Yarrow, George (1991) 'Economic Perspectives on Privatization', *Journal of Economic Perspectives*, 5(2): 111–32.

Walder, Andrew (1994) 'The Varieties of Public Enterprise in China: An Institutional Analysis', unpublished paper, Harvard University.

Weitzman, Martin and Xu, Chenggang (1994) 'Chinese Township-Village Enterprises as Vaguely Defined Cooperatives', *Journal of Comparative Economics*, 18(2): 121–45.

Wright, Erik O. (ed.) (1996) *Equal Shares: Making Market Socialism Work* (London: Verso).

Young, Alwyn (1995) 'The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience', *Quarterly Journal of Economics*, 110(3): 641–80.

Zhuang, Juzhong (1996) 'Estimating Distortions in the Chinese Economy: A General Equilibrium Approach', *Economica*, 63(252): 543–68.

5

Is State Ownership Consistent with a Market Economy? The Chinese Experience*

Weiying Zhang

Introduction

What is market socialism? While different scholars might hold different views, a generally accepted definition is that market socialism is an economic system in which the public ('all people') own the enterprises and their economic decisions are coordinated by market prices. Simply speaking, market socialism is public ownership plus the market mechanism.[1] In practice, public ownership usually takes the form of state ownership; that is, the state (government) is the legal owner of all firms. Here, ownership is defined by who can lay claim to the residue and control over management.

With this definition, the Chinese economic reform process can be taken as an unprecedented experiment of market socialism in human history. So far, the Chinese government has never intended to give up socialism and the Chinese Communist Party's official ideology has always insisted that state ownership is the cornerstone of socialism. However, the Chinese government has indeed tried to introduce a market price mechanism into its state ownership-dominated economy since 1979. It is in this sense that scholars both in China and outside interpret Chinese reform as a 'market-oriented reform'. Before 1984, the official reform objective was to improve and perfect the public ownership-based planned economy by introducing some market elements at the margin. In 1984, 'planned commodity economy' was officially adopted as the objective model of reform by the 3rd plenum of the 12th Chinese Community Party Committee. In the then Chinese vocabulary, 'commodity economy' was more or less a 'soft' version of 'market economy regulated by the state'. The attributive 'planned' was added partly to avoid ideological controversy and partly because the government did not have full confidence in market mechanisms. In 1992, 13 years after the reform began, the 14th Chinese Communist Party Congress eventually adopted 'socialist market economy' as the objective model for reform, and thus 'the market economy' was legitimized.

Here, I need to point out that while I interpret the Chinese economic reform as an experiment in 'market socialism', I do not mean that the Chinese government has ever had any intention that the economy should be purely state-owned. To the contrary, even in the pre-reform era, non-state sectors (mainly collectively-owned enterprises and farms) coexisted with state sectors in China. Since reform, private businesses, township and village enterprises, and foreign-invested enterprises have developed rapidly. As a result, today's Chinese economy is more like a 'mixed economy' in terms of ownership structure. In industrial sectors, state-owned enterprises (SOEs) account for about one third, or even less, of output. Furthermore, even some so-called 'SOEs' have some non-state shareholders. However, in Chinese official statements, non-state sectors could only be a 'supplement' to the state ownership, and state ownership must permanently maintain its dominant position in the whole economy. It is in this sense that I say the Chinese reform is an experiment of market socialism rather than one of a 'mixed economy'. I will argue later that the diminishing of the state sector is itself strong evidence of inconsistency between state ownership and market competition.

The key issue of market socialism is whether state ownership is consistent with market competition. Within China, economists hold different or even opposite views on the issue. Some economists (called the 'competition school') think that ownership is irrelevant as long as there is 'full competition' in product markets, and state ownership can be consistent with a market economy. And it is competition rather than ownership that is the indispensable component of the market economy. Thus, what the government needs to do with SOEs is to separate firms from government control (*zhengqe fenkai*), to give firms full autonomy, and to create a level playing field for competition.[2] Another group of economists (called the 'ownership school') has argued that a market economy cannot be based on state ownership; and only under private ownership does a market economy work efficiently! Therefore, privatization is inevitable in order for a market economic system to be successfully established.[3]

The astonishing performance of Chinese economic reform (in terms of GDP growth rate as well as other economic indexes) is also cited by some economists beyond China as evidence that market competition can be independent of the ownership structure and an economy can be very successful even in the absence of well-defined property rights: this view is particularly echoed by Stiglitz (1994), among others.

Based on Chinese reform experiences, as well as on the author's previous researches, this chapter argues that state ownership is inconsistent with a market economy; and competitive behaviours of firms cannot be independent of the ownership structure. I share Putterman's argument that the Chinese experience has demonstrated that market socialism has little chance of long-run viability unless strong barriers to the growth of private enterprises are afforded by constitutional or policy constraints (Putterman, ch. 4). In particular, I show that:

1. in a state-owned economy, 'full competition' must be excessive competition, and competitive behaviours of SOEs can be very destructive with regard to social efficiency;
2. competition under state ownership can result in extremely excessive entry;
3. the reputation mechanism for market orders is not workable under state ownership; and
4. SOEs could not survive long under market competition and competition will eventually lead to privatization of SOEs.

Excessive (or vicious) competition

According to the fundamental theorems of welfare economics, every competitive economy is Pareto-efficient, and every Pareto-efficient allocation could be attained through the use of market mechanisms. Efficiency of a market economy depends greatly upon the firm's behaviour with regard to the maximization of profit. In the competitive market, the optimal pricing rule of a profit-maximizing firm implies that the price equals the marginal cost, a condition for social optimum. In reality, because of externalities and market power, attempting to maximize profit does not always lead to Pareto efficiency and the market could fail. However, with proper government intervention, market competition can still approximate to an allocative efficiency of the economy.

It is widely accepted that a planned economy is inefficient, partly because the central planner has insufficient information to make the correct decisions, and partly because enterprises are not maximizing profits. Market socialism does not reject the fundamental theorems of welfare economics. It is, rather, based on fundamental theorems (Stiglitz, 1994). It presumes that market competition could be perfectly installed in a state-owned economy and, as long as SOEs are motivated by the maximization of profit, socialism could attain the same efficiency as a capitalist market economy.

While it was not explicitly stated, this has been the underlying doctrine that has guided the Chinese economic reform process. State sector reform in China began with granting decision rights (including those over production, investment and pricing) to managers, and providing bonus and profit sharing incentive schemes. For a considerable while, the degree of managerial autonomy was a basic official measure of the reform process and its success. Various reform policies were subsequently implemented to increase managerial autonomy and market competition (Groves *et al.*, 1994; Zhang, 1997). It was assumed that once SOE managements were able to make their own decisions and compete with each other in the market, the reform would be complete.

Roughly speaking, by 1995, in most sectors, SOEs were almost free to make their own production decisions and to compete with each other. They did not even need to deliver dividends to the government (the 'owner'). In other words, they enjoyed as much freedom as their capitalist counterparts in product markets but bore no equity costs. However, the consequence was surprising, very different from that which had been expected. Particularly in the second half of 1990s, it was frequently reported that many SOEs undercut each other's prices, and product prices were deliberately set below marginal costs. The state sector experienced massive losses. The Chinese media called this kind of pricing behaviour 'vicious competition'. I refer to it as 'excessive competition'. Excessive (or vicious) competition had become so serious that, in the mid-1998, the State Economic and Trade Commission of China had to issue a regulatory document forbidding SOEs to cut prices, a major reversal of the liberalization of pricing policy.

In the Western market economy, except in the case where dominant firms try to monopolize the market by driving out their competitors, we hardly observe such massive excessive competition in competitive sectors where no firm has any prospect of monopolizing the market. Why does excessive competition exist in the transitional Chinese economy? What is the particular condition under which an SOE will engage in such pricing behaviour?

In Zhang and Ma (1999), we set up a theoretical model to address these issues. Our basic argument is that distortion by virtue of ownership might induce managers to conduct excessively competitive practices. In the traditional theory, the objective of the firm is summarized by a profit function or some variable proportional to profit. Profit maximization could be a good approximation for the objective of a classic capitalist firm or even a listed private firm. However, it is definitely not a good approximation of the objective of a SOE. Let me provide a detailed explanation.

Any economic decision will generate both benefit and cost. Full private ownership can be understood as the decision-maker's full internalization of the benefit and cost of economic decisions. Thus, in the context of the firm, we can measure ownership distortion by a ratio of the manager's share in the firm's sales revenue to their share of the firm's cost. Here, in a static model, both the revenue and the cost should be interpreted as the discounted present values of lifetime cash flows of a production decision. The manager's share of revenue is denoted by β, and the share of cost by α.[4] Then, ownership distortion can be measured by $\gamma = \beta/\alpha$: $\gamma = 1$ means no ownership distortion; when $\gamma \neq 0$, distortion occurs. The further γ is from 1, the greater the distortion.

Let us assume that the manager maximizes his own utility (equal to his personal revenue minus personal cost), whatever the ownership of the firm. In a private owner-controlled firm, $\beta = \alpha = 1$, $\gamma = 1$; that is, the manager is fully responsible for both revenue and cost, and there is no ownership distortion. Profit-maximization behaviour would not lead to excessive competition, whatever the structure of the market. Even under separation of control from ownership where $\beta < 1$, $\alpha < 1$, as long as $\beta = \alpha > 0$, $\gamma = 1$ still holds, and there is no ownership distortion. In this case, the manager's objective function is still equivalent to profit-maximization, and excessive competition would not occur.

However, in the case where a manager's revenue share is not equal to their cost share – that is, $\alpha \neq \beta$, and thus $\gamma \neq 1$ – the manager's utility-maximizing behaviour is different from that of profit-maximization. In a static Cournot model, it is easy to show that when ownership is sufficiently distorted (that is, γ is sufficiently large), a manager will optimally set the price below marginal cost, and excessive competition will occur. This is demonstrated in Figure 5.1, where the manager's optimal price is lower than marginal cost. Furthermore, the greater the number of firms with $\gamma > 1$, and the more elastic the demand, the more likely competition will be excessive.[5]

This theoretical model fairly captures the competition behaviour of SOEs in the transitional Chinese economy. In pre-reform China, both the revenues and costs of SOEs were centrally budgeted, and production decisions were made and prices fixed by government departments.[6] Since the reform, managers have acquired considerable production decision rights. At the same time, various incentive systems have been introduced into the state sector (Zhang, 1997). Although many incentive contracts are

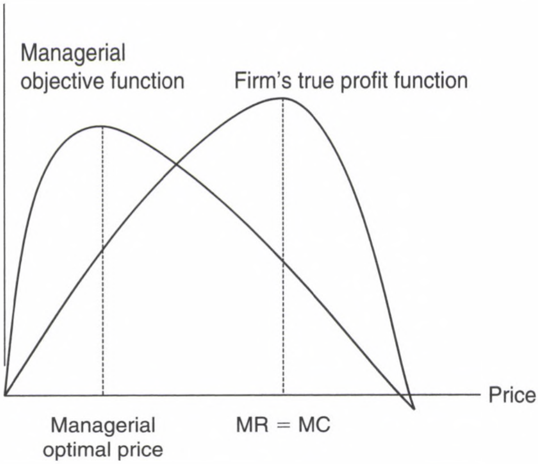


Figure 5.1 Ownership distortion and excessive competition

usually profit-based, both pecuniary bonuses and non-pecuniary perks for managers are considerably more dependent on the revenue than the cost. The reason is that measuring sales revenue is much easier than measuring costs. Typically, revenue is realized in accounting records immediately after sale, while production costs can be easily spread over a much longer period. Furthermore, given that the managerial appointment of SOEs is based on short-term contracts (explicit or implicit), a manager has every incentive to make money quickly, achieved by manipulating accounting entries through putting off losses, as demonstrated in Figure 5.2. For instance, it is widely reported that SOE managers often under-report fixed asset depreciation as well as other kinds of measurable costs, thereby delaying the updating of technology. They even 'make' profit by defaulting on state bank loans. In addition, many costs are often unaccountable unless the manager is an owner of the firm. As a result, the SOE manager's share in sales revenue is typically larger than that in the production costs he has to bear, even if the incentive contract is accounting profit-based. Thus, we can naturally refer to today's SOE as the firm with $\gamma > 1$. This explains why excessive competition occurs in most competitive industries.

We can also reinterpret excessive competition of SOEs in the context of Holmstrom and Milgrom's (1991) multi-task model. Within this setting, the manager has two tasks, revenue increase and cost control. Given that the cost is more difficult to observe, revenue-based incentive outweighs cost-based incentive. The overall incentive would be distorted

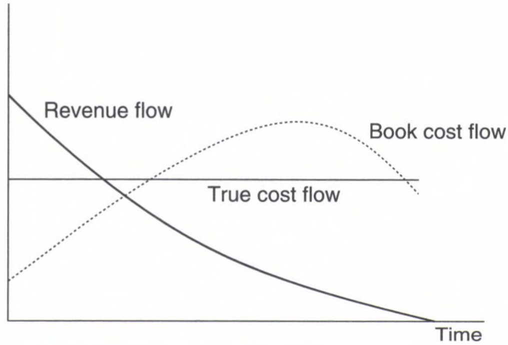


Figure 5.2 Cost manipulation behaviour

in favour of revenue maximization rather than profit maximization. Excessive competition will follow.

To complete my argument, I must address the issue as to why the separation of ownership from management in Western private economies does not lead to the pervasive excessive competition as experienced in state ownership in China. I believe that the fundamental reason is the nature of ownership. There is an essential difference between the state-owner and the private owner. Truly, as Sklivas (1987) argued, even in a Western-listed company, given that shareholders do not manage the firm directly, the separation of ownership from management, and the complexities of operation decisions which that leads to, could make the firm deviate from the choice of profit maximization. However, private shareholders in these companies have sufficient incentive to design incentive schemes for and monitor their managers so as to make γ as close to 1 as possible, because their personal interests are strongly related to the firm's long-run performance. In contrast, ownership of an SOE belongs to 'all of the people'. That all are owners means there is no owner at all. The people, as the original owner of the firm, not only lack relevant information, but also have no effective means by which to monitor their managers. They cannot be motivated to provide incentives for their agents and do not even have self-incentives (to be the owners) because of the 'free ride' problem. In fact, the original owners of an SOE do not have 'behavioural abilities'. This is particularly true when the size of the owner population and the size of the state sector are extensive, as is the case in China (Zhang, 1998a). By means of a long chain of delegation, the state is the legal owner of SOEs; however, politicians and bureaucrats run the state. Neither politicians nor bureaucrats have any legal claim on a firm's profits. Bureaucrats as agents suffer from the same distortion of incentive as SOE managers. They are also short-lived in their positions. Why should they behave as private owners to make γ close to 1? It is not surprising that bureaucrats often collude with managers in the misappropriation of state assets rather than the monitoring of managers. Even bureaucrats have the intention of designing an incentive-compatible contract for managers: lack of sufficient information implies that such an incentive is inevitably of the 'one-size-fits-all' type. Given that enterprises differ in many respects from each other, a 'one-size-fits-all' contract can only contain very limited control variables. As a result, managerial autonomy means insider control, and managers will enjoy excessive freedom to manipulate accounting entries. Excessive competition is more likely to occur.

Another important difference between the state economy and Western private economies is that in the Western economy, both the capital market and the managerial labour market play very important roles in disciplining and motivating managers. However, neither of these two mechanisms exists in the state economy, given that all means of production are owned by the single state-owner. This implies that the state-owner has much less information and fewer means by which to discipline managers. When managerial reputation is not valued in markets, how can managers have any incentive to build up a good reputation, as seen in Western economies?

To summarize, in this section, I have argued that the excessive competition in product markets (that is, setting prices below marginal costs) observed in China is a natural phenomenon of state ownership when SOEs are granted the autonomy to make decisions. A general implication is that in a state-owned economy, 'full' competition must be excessive competition, and 'perfect' competition is inconsistent with the Pareto optimum. When the competition school argues that ownership is irrelevant as long as there is sufficient competition in product markets (Stiglitz, 1994; Lin *et al.*, 1998), it is implicitly assumed that competitive behaviour is independent of the ownership structure. However, the Chinese experience has shown that competitive behaviour cannot be independent of the ownership structure. Without a fundamental change of ownership, 'sufficient competition' can be very destructive.[7]

Given that price is set below marginal cost, how could SOEs survive in the long run? The answer is that SOEs are, explicitly or implicitly, subsidized by the government; that is, because of soft budget constraints (Kornai, 1986). Without government subsidy, excessive competition would eventually result in the collapse of SOEs. One implication is that as the government's budget becomes exhausted, privatization of SOEs will follow. I shall discuss privatization later in this chapter.

Excessive entry

The efficiency of markets depends not only the behaviour of existing firms but also on the entry of new firms and exit of inefficient firms. The process of entry and exit determines the dynamics of market structure and efficiency. In particular, as envisioned by Schumpeter (1934), economic development involves a process of 'creative destruction', in which competition in the innovation of technology performs the role of a filter – selecting the winners and driving out the losers.

However, there has been no general theory to show that the market equilibrium number of firms in a private economy will necessarily be socially efficient. To the contrary, some theoretical models have shown that market equilibrium tends to generate excessive entry; that is, too many firms in terms of the social optimum (Mankiw and Whinston, 1986; Suzumura and Kiyono, 1987). In particular, it is often argued there should be restricted entry into industries with economies of scale because free entry could lead to the undesirable duplication of fixed costs (Vickers and Yarrow, 1988).

For many proponents of socialism, excessive entry and duplication are evils of private ownership. They claim that excessive entry and duplication could be eliminated under state ownership, since there is no conflict of interests between different firms and all firms have a common goal. Even when excessive entry and duplication do occur for any reason, the government can successfully solve the issues through administrative interventions (such as close-downs, mergers and acquisitions).

Ironically, Chinese experience has demonstrated the opposite. Not only has state ownership failed to eliminate excessive entry and duplication, it has led to further excessive entry and duplication when compared with Western economies. Even under the pre-reform regime, when the government made all decisions regarding entry and exit, excessive entry and duplication comprised the most serious and lasting headache for the government. Several cyclical administrative restructurings were launched to deal with the problem. Since the beginning of reform, many entry restrictions have been gradually abolished and both local governments and state enterprises have acquired considerable investment decision rights. Progressively more industries are also open to private investors and foreign investment. As a result, excessive entry and duplication have worsened. What we observe today is that, except for few state monopolized sectors (such as petrol, railroad, airlines and banks), most Chinese industries contain too many small-sized 'atomic' firms, with no dominant players. In terms of the number of firms, the Chinese economy might be the most 'competitive' economy. Compared with Western and even many developing economies, most Chinese industries are much less concentrated. For example, in 15 manufacturing sectors, only the petrol refining sector has a 4-firm concentration ratio of above 40 per cent, three sectors between 20–30 per cent, and the remaining 11 sectors are all below 20 per cent (5 sectors below 8 per cent) (Yin, 1996).

Along with excessive entry and duplication, we also find that it is more difficult for efficient mergers and acquisitions to take place. Failing state-owned firms are extremely resistant to being taken over or closed down. Even insolvent firms have no need to exit. As Zhang Ruiming, CEO of Haier Group, vividly described, as long as it has one breath remaining, a state firm would not be willing to be swallowed.

Why is entry more excessive and duplication more serious under state ownership? Why is it more difficult to achieve mergers and acquisitions in state sectors? A conventional Chinese argument is that excessive entry and duplication originate from 'regional, departmental and firms' self-interests'. For example, under the Chinese tax-sharing system, local governments blindly make investments and build new factories only for the purpose of increasing their local tax revenues and employment, in ignorance of social efficiency: managers are resistant to being taken over because they worry about the loss of their positions and power. However, this type of argument merely illustrates the existence of the problem, rather than providing an answer. After all, one cannot say that interests under state ownership are more dispersed than those under private ownership. In a private economy, every enterprise is an independent entity with its own objective, and it makes investment decisions to maximize its own profit. However, we have not observed excessive entry to be so pervasive as in China. Rather, merger and acquisition, either friendly or hostile, frequently happen.

In Zhang (1998b), I explained that the pervasive phenomenon of excessive entry and duplication in a state economy is rooted in the nature of the state ownership of the firm. As widely recognized by scholars of the theory of the firm, the firm generates two types of return: cash flow (called 'profit' for simplicity) and control benefits (Aghion and Bolton, 1992; Hart, 1995). The difference between cash flow and control benefits is that cash flow can be distributed in terms of a formal ownership structure and it is transferable: control benefits are attached, non-transferable, and can be enjoyed only by managers or controlling shareholders. Here, control benefits can be understood as all private returns related to the managerial position that managers privately value, including perks, nepotism, power, social prestige, and so on. The condition of entry equilibrium depends upon how cash flow is matched (or mismatched) with control benefits.

In an owner-managed economy, managers appropriate both profit and control benefits. The market equilibrium number of firms when there is free entry is given by the condition that the marginal firm's total value (the sum of cash flow and control benefits) is equal to zero.[8] In an economy where there is separation of ownership and control, cash flow and control benefits are vested in different people, and the condition of equilibrium is more complicated, depending on incentive schemes and the allocation of authority.

In a state-owned economy, cash flow belongs to 'all people' (or the state), and managers can only enjoy control benefits.[9] Even when managers share some of the cash flow (either explicitly or implicitly), their share of cash flow is still attached to their position and is non-transferable. Therefore, we can still refer to this situation as relating to control benefits. In the pre-reform regime, bureaucrats made the investment decisions. In the Chinese transitional economy, as SOE managers have obtained more autonomy, SOE investment decisions are made jointly by managers and bureaucrats. However, in both situations, within certain limits, decision-makers are driven by private benefits. Therefore, we can reasonably assume that entry equilibrium is determined by the condition that further entry brings about the zero control benefits, rather than zero total value or zero profit.

In Figure 5.3, I show how cash flow, control benefits and total value change with the number of firms in an industry. When the number of firms is very low, a small number of oligopolists have substantial market power, and both the cash flow and the control benefits are considerable. As the number of firms increases, markets become more competitive, and both cash flow and control benefits fall. Control benefits fall for two reasons: first, a lower level of cash flow means there are fewer available perks; second, the existence of a greater number of managers means that being employed as a manager carries less prestige. We can further assume that cash flow falls faster than control benefits. After all, even when the firm makes a loss, the manager can still appropriate some control benefits. Thus, the cash flow and the total value diminish to zero earlier than the level of control benefits. The equilibrium number of firms in a private economy (denoted by N^*) is lower that in a state economy (denoted by N').[10]

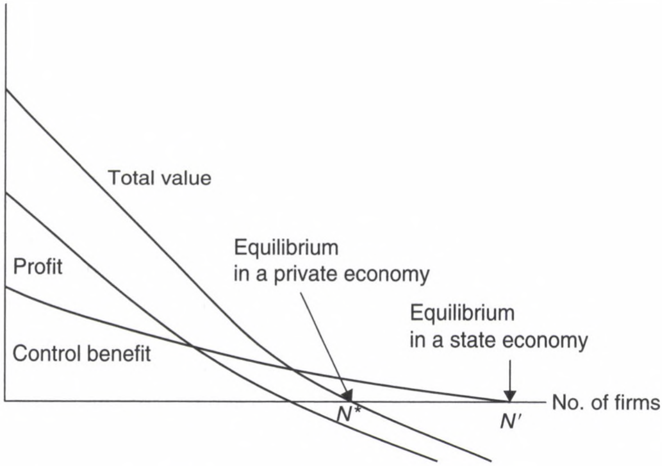


Figure 5.3 Equilibrium number of firms

Thus, I have shown that the state-owned economy suffers far more from excessive entry and duplication. Casual observations strongly support this argument. For example, assume that the social optimal number of car manufacturers is 5. However, the government officials in charge might choose to build 50 car factories, instead of 5, because they now can appoint 50 general managers and can therefore bestow greater favours on their relatives and friends. While the whole industry, which is attempting to support 50 car manufacturers, makes a loss, no one cares.

The same logic can also explain why mergers and acquisitions in the state sector are more difficult to achieve. In a private economy, the manager of the target firm may lose their control benefits after the merger. However, if the merger is efficient in terms of maximization of total value, as an owner, the manager can be compensated by increases in cash flow. The merger can be a Pareto-improvement for all parties concerned. In contrast, in a state-owned economy, the loss of control benefits by the manager of the target firm cannot be compensated for in any legal manner through increases in cash flow. Thus, the target manager has every incentive to resist the merger in order to protect control benefits, unless the government offers that manager another equivalent position.

I now turn to discuss the private economy, with separation of control from ownership. Truly, this separation can lead to various managerial discretionary behaviour. However, for the following reasons, that discretion might not be very serious in cases of entry and acquisition when compared with state ownership. First, even when the shareholders are not the managers, it is the shareholders or the board of directors, rather than managers, that, in the main, make entry and merger decisions. This allocation of authority actually implies that the state of equilibrium is more likely to be 'break-even'. That is, when compared with an owner-managed economy, there might be too few entries and too many mergers. Second, in most listed private firms, CEOs hold some shares and, in some cases, are even the largest shareholders. Thus, even though the merger wipes out their control benefits, they can still be partly compensated by cash flow increases. Third, in the interest of their own cash flow, the shareholders of the target firm have incentives to buy out the manager through cash compensation (such as a golden parachute) to mitigate the manager's resistance. In contrast, the 'owners' (people) of the state firms have neither a legal right nor an incentive to buy out the manager who will lose control. Fourth, in a market economy with private ownership, many mergers and takeovers can be conducted by directly offering to shareholders in stock exchanges. This type of mechanism is not available in the state-owned economy.

My argument is also supported by certain empirical studies. For example, using panel data from a Chinese high-tech park, Li, Zhang and Zhou (2005) show that, while efficiency has become an important factor for the survival of all high-tech firms, *ceteris paribus*, state-owned firms are less likely to exit than non-state firms. In particular, the financial distress has a lesser negative effect on the survival of state-owned firms than non-state firms, and the least effect on that of central government controlled firms.

Lack of a mechanism of reputation

Markets are coordinating devices of transactions and economic activities. In almost all cases, transactions are nothing more than exchanges of promises and economic activities are nothing more than performing promises. Markets cannot work effectively and efficiently without sufficient mutual trust between the transacting parties. For example, if a buyer does not trust a seller regarding the promised quality of a particular product, he would be reluctant to pay for it; if investors do not believe what an investment bank has said about a company in need of capital, it is unlikely that they would buy that company's stocks; and if a bank has no confidence in the borrower to repay, it would be foolish to make a loan. In all these cases, without trust, potential Pareto efficiencies could not be realized. In general, without trust, division of labour and specialization would not occur, and cooperation through markets becomes impossible.

Trust is important but it is also difficult to build. The main reason for this difficulty is asymmetry of information between the transacting parties, and the informed party's behaviour with regard to moral hazard. As Akerlof (1970) demonstrated, information asymmetry can lead to market failure. Nevertheless, one should not rush to conclude that the asymmetry of information would necessarily result in a market collapse. The assumption of perfect information is the flaw of neo-classic economics of markets, but definitely not the flaw of the market mechanism itself. We must realize that markets are not only an invisible hand, but are also an 'invisible eye' that observes and polices agents' behaviour (Shearmur and Klein, 1997). That is the mechanism of reputation. While the government-supported legal system might be necessary for agents to keep their promises in certain cases, everyday experience and numerous scholarly studies suggest that official contract enforcement is often costly and impractical. It is the market-based reputation that maintains the integrity of activities in most cases. Anyone who intends to survive in competitive markets for any length of time must build a good reputation for trustworthiness otherwise markets would drive them out. In a market economy, reputations and brand names are the most valuable assets and competitive advantage for a firm. As Adam Smith said a long time ago, honesty is the best business policy. Markets have created numerous intermediaries (such as firms, investment banks, credit-rating institutions and so on) that make possible cooperation that would otherwise be impossible, even cooperation between strangers. In human history, there has been no other institution where reputation is so valuable and plays such an important role as that in market economies. In contrast to the conventional argument, that markets may not work when there is asymmetric information, I would like to argue that asymmetry of information might simply be another – or, probably, the main justification – for a need for market mechanisms. Without information asymmetry, a planned economy might be just as efficient as a market economy! With information asymmetry, markets could work much better! It is extremely unfortunate that neither neo-classic economists nor market socialism has put sufficient emphasis on the reputation mechanism of a market economy.

In terms of firms' autonomy and price liberalization, one may claim that the Chinese economy has been greatly affected by the market mechanisms. However, Chinese markets are very disorderly. Cheating and faking are pervasive, contracts are often not honoured, and state-owned enterprises frequently default on bank loans (resulting in bad debt that accounts for about 25 per cent of total bank loans). Disorders exist not only in the products and credit markets, but also in securities markets. Since the establishment of the two stock exchanges (Shanghai and Shenzhen) in 1992, SOEs have been dominant players in raising capital. Listed SOEs have taken the stock exchanges as their cash machines. They manipulate accounting entries, cheat private investors, and care little for their reputation. A great many listed firms have committed fraud. Since 1993, about 200 listed firms from 1200 have been subject to enforcement action by the China Security Regulation Committee (CSRC), Shenzhen Stock Exchange (SZSE) and Shanghai Stock Exchange (SHSE). The ratio of firms committing fraud in all listed firms in China is far above the ratio of firms causing scandal in other countries, such as the US (Zhang and Ma, 2005). As a result, the 13-year-old stock exchanges are almost ruined by state-controlled listed companies.

Why are Chinese markets so disorderly? Why do state-owned enterprises care so little about their reputation? One may argue that the reason is that market-friendly legal systems have not been well developed in China. While this is partly true, I deeply believe that the problems originate in the nature of state ownership (Zhang, 2001). The reputation could come only from repeated games. For one to have incentives to build a good reputation, one must have a long-run expectation and must be willing to sacrifice short-term interests in exchange for future returns. Clearly defined private property rights provide owners with proper incentives to play a repeated game. By contrast, under state ownership, everyone plays a one-shot game and reputation has no value. Making quick money is their best strategy.

In particular, as Kreps (1990) pointed out, in a market economy, the firm is the bearer of reputation. However, for the firm to bear reputation, the following three conditions must hold:

1. The firm must have real owners. As previously stated, reputation is the most important (intangible) asset in a market economy. The most tangible assets of a firm are actually its operating costs, not the true value of the firm. Ownership of the firm is actually defined by who has a claim to the residual reputation of the firm. The role of owners is to maintain and enhance the firm's reputation. This is particularly true when the firm employs many people and anyone's misconduct could damage its reputation. Without true owners, no one would take care of the firm's reputation, and the reputation would be lost.
2. The name of the firm must be tradable in markets. The value of reputation is embedded in the firm's name. It can be fully appropriable only

when the owner has freedom to transfer it for economic return. How much incentive the owner has for maintaining and enhancing the firm's reputation depends greatly upon tradability. When tradability is legally restricted, reputation becomes less valuable. For example, if McDonald's were not franchisable, the firm would not be worth so much.

3. There must be free entry and exit in markets. In the absence of free entry and exit, the firms with good reputations could not drive out a firm with a bad reputation. As a result, an incumbent firm could enjoy great monopoly rents. When consumers could not punish a firm's dishonest behaviour, reputation is less valuable.

Thus, we can easily explain why state-owned firms do not care about reputation. When a firm is owned by the state, no one has a residual claim over its reputation. The name of the SOE usually is not tradable. Even when traded, it could not be correctly priced because the 'seller' cannot appropriate the sale revenue. The restriction of the entry of private firms and soft budget constraints also make the survival of SOEs less dependent on their reputation. When government bureaucrats' interests are not related to the firm's reputation, why should they care about it? Given that the bureaucrats have no proper incentive to make managerial appointments on the basis of merit, SOE managers feel very insecure about their positions, and they have no future to care about. Therefore, they have every incentive to play the one-shot game to make quick money. All these factors lead to a failure of reputation. Taking an analogy, reputation is like a tree. The manager of an SOE might have an incentive to grow grass, but definitely not to plant trees.

To conclude, the 'invisible hand' of the free price system and the 'invisible eye' of the mechanism of reputation, together, make markets work. In a state economy, even if the price system is set free, the reputation mechanism could not work well. Therefore, state ownership-based markets are inevitably disorderly.

Competition-driven privatization

While many scholars have claimed Chinese economic reform as the transition to a market economy, unlike most Eastern European and former Soviet Union countries, the Chinese government never intended to give up socialism. For the Chinese Communist Party, state ownership is the cornerstone of socialism; and without state ownership, China would not be a socialist country any more. The goal of reform has simply been to improve the public ownership-based economy by introducing market competition, rather than to establish a private ownership-based market economy. Privatization has never been adopted as official reform policy. The scholars who argue for privatization are often denounced as 'capitalist liberalists'.

However, the consequences of reform went far beyond what they were supposed to be. Today's reality is that, while state-owned enterprises are still dominant in some key industries (including the oil, electricity, telecommunication, and financial sectors), and the government still insists that state ownership should play a dominant role in the whole economy, non-state sectors (including foreign-owned, joint-ventures, mixed ownership and domestic private enterprises) have already become, or are becoming, leading players in many industries. In 1978, nearly four fifths of total industrial output in China came from SOEs. By 1997, the SOE share had shrunk to little more than a quarter (State Statistics Bureau of China 1998: 99). More surprisingly, since the early 1990s, spontaneous and local government-initiated privatization of both state firms and collective firms has been accelerating through various ways, including public offerings, open sale, management/employee buy-out, leases, and joint ventures, under the official name of *gaizhi* (Li, Li and Zhang, 2000; Garnaut, Song and Yao, 2004). By the end of 1998, more than 80 per cent of state and collective firms at or below the county level had undergone *gaizhi*, which involved direct privatization in most cases (Zhao, 1999). A 2002 national survey of industrial SOEs estimated that 86 per cent had been through *gaizhi* by the end of 2001 and that about 70 per cent had been partially or fully privatized.[11] Southern Jiangsu is a particularly interesting case. Up until the early 1990s, Southern Jiangsu models were widely thought of as being 'an economic model of a new type of public ownership' (*sunan mushi*) in comparison with the private ownership-dominated Zhejiang model. However, by the end of 2000, nearly 100 per cent of village-owned firms, 95 per cent of township firms, 90 per cent of county-owned firms and 85 per cent of city-owned firms had already been privatized (China Stock Exchange Executive Council, 2001:5). The Zhejiang private ownership model eventually claimed victory over the Jiangsu public ownership model.

Interestingly, Chinese economic reform began with decentralization rather than the development of a private ownership system, and with revitalization of state firms rather than privatization of them. What are the driving forces behind the unintended and accelerating rise of a private ownership system in China? What has motivated local governments to privatize the enterprises under their control?

In Li, Li and Zhang (2000), we developed a theoretic model to address these issues. In our paper, firm ownership is defined by who holds the residual claim.[12] Privatization is the process of shifting residual claims from government to managers. For ease of exposition, we focus on how cross-regional competition in the product market triggers privatization of SOEs through the interaction between bureaucrats and managers in regional government-controlled public economies.[13] We find that when cross-regional competition is sufficiently intense, each region has to cut production costs. Given that the efforts of managers are not verifiable, local governments might have to grant total or partial residual shares to the managers. In general, intense product competition stimulates the rise of a private property system. We then submitted our theory to a vigorous empirical test using China's industrial census data of more than 400,000 firms. The test strongly supports our postulation that cross-regional competition is the driving force behind China's transition toward capitalism.

While Li, Li and Zhang (2000) focus on how competition induces privatization of existing SOEs, we believe that the same logic can be applied to analyse how cross-regional competition induces the establishment of new private enterprises. As I have pointed out, official open privatization in China has never been adopted as a central government policy. However, competition is far more powerful than ideology. Regardless of whether or not central government will draw up a blueprint for full privatization, both our theory and reality show that the privatization process will continue to accelerate with its own logic and vigour. China has reached a point of no return on the road to capitalism.

The Chinese experience demonstrates that the 'invisible hand' is not only powerful in allocating resources, but it is also powerful in creating institutions. Once decentralization begins, market competition could precipitate a self-enforcing development of a private ownership system. The newly founded and privatized firms, in turn, intensify market competition. This is a major lesson from China's experience.

More generally, the relevance of our theory extends beyond China and former socialist economies. According to a recent World Bank report, SOEs' output still accounts for a large share of the GDP in many countries, including not only transition economies, but also developing economies and even industrial economies (World Bank, 1995: 31 and 56). But across countries and time, SOEs are generally poor performers. In the past decade or more, privatization of state-owned enterprises has taken place not only in socialist and developing economies, but also in developed economies. It is our conjecture that the intensifying cross-country competition resulting from globalization has been, and will continue to be, one of the most fundamental driving forces behind the worldwide movement towards privatization and the transition to capitalism.

Conclusion

Based on Chinese reform experience, as well as on the author's previous research, this chapter has shown that state ownership is inconsistent with a market economy; and competitive behaviour in markets cannot be independent of the structure of ownership of firms. In particular, I have shown that:

1. In a state-owned economy, competition can be excessive (or destructive) in the sense that the state-owned firms are more likely to set prices below marginal costs as competition intensifies.
2. Competition under state ownership could result in extreme excessive entry; that is, too many firms in industries, compared with any private economies.
3. In a state ownership-dominated economy, markets are inevitably disorderly and building trust is more difficult because the reputation mechanism cannot work.
4. SOEs cannot survive long under competition, and competition eventually leads to the privatization or collapse of SOEs.

Putterman could be right when he argues that market socialism might simply be a fly-by, and China will eventually move towards managed market capitalism (Putterman, ch. 4).

One limitation of this chapter is that I have not discussed the political institutions of market socialism. One can argue that state-owned firms might behave differently under different political regimes, and the Chinese experience might not be applicable in general. In particular, political democracy might make state ownership work better. However, I deeply believe that my overall arguments hold, whatever the political system might be. Of course, only history will tell us the truth.

Notes

* The paper on which this chapter is based was prepared for the International Economic Association Round Table on Market and Socialism, in the Light of

the Experiences of China and Vietnam, Hong Kong University of Science and Technology, 14–15 January 2005. Substantial revisions have been undertaken since the presentation. The author thanks all participants and particularly Yijiang Wang for valuable comments.

1. For conceptual clarification of market socialism, see Kornai (2005, and Chapter 2).
2. While this view was either explicitly or implicitly held by most Chinese economists up to the late 1990s, and has been very much an official view that has guided the formation of reform policy during most of the period of reform, Justin Lin may be the best-known representative of this school, see Lin *et al.* (1998).
3. I have been cited as the representative of the ownership school. As early as 1986, I argued that it is impossible to have a separation of firms from governments. See Zhang (1986, 1999).
4. More generally, β may represent the right of control the manager has over the firm and α may represent the responsibilities he must bear in the firm.
5. In this chapter, I also show that in a mixed economy, a private firm could survive if, and only if, its technological productivity is sufficiently higher than that of the state-owned firm.
6. Given that the manager had to bear the cost of effort, this led to the undersupply of such effort.
7. Ironically, the Chinese experience is quite often taken as empirical support for the competition school's arguments.
8. In the standard model, in which only cash flow is concerned, it is assumed that the marginal firm merely breaks even. I believe that it is more realistic to take control benefits into account. However, if the owner-manager is liquidity-constrained, the zero-profit condition might apply.
9. The case of listed private companies will be discussed later in the chapter.
10. This conclusion holds as long as the decision-maker is not a 100 per cent owner. It certainly holds when the manager claims a greater share in revenue than is borne in cost, as was assumed in last section.
11. Unpublished report of the State Economic and Trade Commission, cited from Garnaut, Song and Yao (2004).
12. Traditionally, ownership is defined by who can lay claim to the residual rights. Grossman and Hart (1986) define ownership as being rights of control over assets. Economists presently recognize that both residual claims and control rights are essential to ownership. Here, I omit control rights not because they are irrelevant but because of technical intractability. Nevertheless, it is my conjecture that my results apply to control rights as well. Furthermore, given that SOE managers have obtained considerable autonomy of decision, I believe that the transfer of residual rights is just the completion of privatization. That is, as the manager holds all the residue of the firm, he becomes the *de facto* owner of the firm.
13. Cao, Qian and Weingast (1999) argue that federalism, Chinese style, has induced privatization. However, one question these authors do not address, at least not formally, is how cross-regional competition stimulates the rise of a private ownership system.

References

Aghion, Philippe and Bolton, Patrick (1992) 'An "Incomplete Contracts" Approach to Financial Contracting', *Review of Economic Studies*, 59: 473–94.

Akerlof, George A. (1970) 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', *Quarterly Journal of Economics*, 84: 488–500.

Cao, Yuanzheng; Qian, Yingyi and Weingast, Barry R. (1999) 'From Federalism, Chinese Style, to Privatization, Chinese Style', *Economics of Transition*, 7(1): 103–31.

China Stock Exchange Executive Council (2001) *Caijing Magazine*: 5.

Garnaut, Ross; Song, Ligang and Yao, Yang (2004) 'SOE Restructuring in China', in *China's Policy Reforms: Progress and Challenges*, Tsinghua University and Stanford Center for International Development.

Grossman, S. and Hart, Oliver (1986) 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration', *Journal of Political Economy*, 94: 691–719.

Groves, T.; Hong, Yongmiao; McMillan, John and Naughton, Barry (1994) 'Autonomy and Incentives in Chinese State Enterprises', *Quarterly Journal of Economics*, 109: 202–26.

Hart, Oliver (1995) *Firms, Contracts and Financial Structure* (New York: Oxford University Press): chs 5–6.

Holstrom, Bengt and Milgrom, Paul (1991) 'Multi-task Principal-Agent Analysis', *Journal of Economic Behavior and Organization*, 7: 24–51.

Klein, Daniel (ed.) (1997) *Reputation: Studies in the Voluntary Elicitation of Good Conduct* (Ann Arbor: University of Michigan Press).

Kornai, János (1986) 'The Soft Budget Constraint,' *Kyklos*, 39(1): 3–30.

Kreps, David (1990) 'Corporate Culture and Economic Theory', in *Perspectives on Positive Political Economy*, Alt, James and Shepsle, Kenneth (eds) (Cambridge: Cambridge University Press).

Li, Hongbin; Zhang, Weiying and Zhou, Li-an (2005) 'Ownership, Efficiency, and Firm Survival in Economic Transition: Evidence from A Chinese Science Park', Working paper, Guanghua School of Management, Peking University, available from authors.

Li, Shaomin; Li, Shuhe and Zhang, Weiying (2000) 'The Road to Capitalism: Competition and Institutional Change in China', *Journal of Comparative Economics*, 28: 269–92.

Lin, Justin; Cai, Fang and Li, Zhou (1998) 'Competition, Policy Burdens, and State-owned Enterprise Reform', *American Economic Review*, May 1998 (Papers and Proceedings), 88 (2): 422–7.

Mankiw, N.G. and Whinston, M.D. (1986) 'Free Entry and Social Inefficiency', *Rand Journal of Economics*, 17: 48–58.

Schumpeter, Joseph A. (1934) *The Theory of Economic Development* (Cambridge, MA: Harvard University Press).

Shearmur, Jeremy and Klein, Daniel (1997) 'Good Conduct in the Great Society: Adam Smith and the Role of Reputation', in Daniel Klein (ed.) *Reputation Studies in the Voluntary Elicitation of Good Conduct* (Ann Arbor: University of Michigan Press).

Sklivas, Steven (1987) 'The Strategic Choice of Managerial Incentives', *Rand Journal of Economics*, 18(3): 452–8.

State Statistical Bureau (1998) *Statistical Survey of China 1998* (Beijing: State Statistical Publishing House).

Stiglitz, Joseph E. (1994) *Whither Socialism?* (Cambridge, MA: MIT Press).

Suzumura, K. and Kiyono, K. (1987) 'Entry Barriers and Economic Welfare', *Review of Economic Studies*, 54: 157–67.

Vickers, John and Yarrow, George (1988) *Privatization: An Economic Analysis* (Cambridge, MA: MIT Press).

World Bank (1995) *Bureaucrats in Business: The Economics and Politics of Government Ownership* (Oxford/New York: Oxford University Press).

Yin, Xingmin (1996) 'Industrial Concentration and Efficiency of Resources Allocation in Chinese Manufactories', (*Zhongguo Zhichaoye De Chanye Jizhongdu He Ziyuan Peizhi Xiaolv*), *Journal of Economic Research* (*Jingji Yanjiu*), 1.

Zhang, Weiying (1986) 'Entrepreneurship and Ownership' (*Qiyejia Yu Suoyouzhi*), Working paper no.30, China Institute for Economic System Reform.

Zhang, Weiying (1997) 'Decision Rights, Residual Claims and Performance: A Theory of How Chinese State Enterprise Reform Works', *China Economic Review*, 8(1): 67–82.

Zhang, Weiying (1998a) 'A Principal-agent Theory of the Public Economy and Its Applications to China', *Economics of Planning*, 31: 231–51.

Zhang, Weiying (1998b) 'Non-transferability of Control Benefits and Property Rights Barriers to Merger and Acquisitions in State Sectors' (*Kunzhiquan De Buke Buchangxing He Guoyou Qiye Jianbing Zhongde Chanquan Zhangai*), *Journal of Economic Research* (*Jingji Yanjiu*), 7.

Zhang, Weiying (1999) *The Theory of the Firm and Chinese Enterprise Reform* (*Qiye Lilun Yu Zhongguo Qiye Gaige*), Peking University Press.

Zhang, Weiying and Jie, Ma (1999) 'Ownership Foundation of Vicious Competition', (*Exing Jinzheng De Chanquan Jichu*), *Journal of Economic Research* (*Jingji Yanjiu*), 7.

Zhang, Weiying (2001) *Property Rights, Governments, and Reputation* (*Chanquan, Zhengfu Yu Xinyu*) (Beijing: Sanlian Publication).

Zhang, Yi and Ma, Guang (2005) 'Law, Economic, Corporate Governance, and Corporate Scandals in a Transition Economy: Insight from China', Working paper, Guanghua School of Management, Peking University.

Zhao, Xiao (1999) 'Competition, Public Policy and Institutional Change', CCER Working paper no. C1999025, Peking University.

6
Market Socialism or Capitalism? Evidence from Chinese Financial Market Development*

Julan Du and Chenggang Xu

Introduction

The cornerstone of market socialism, according to Lange (1936; 1937), Lerner (1947), and Taylor (1929), is the public ownership of the means of production, and the state is regarded as the default representative of the 'public.' Associated with this basic feature, the market socialism literature emphasizes the role of the state in governing markets in resource allocation. The most important coordination mechanisms that a market socialist economy relies on are the administrative mechanism (or 'bureaucratic coordination mechanism' (Kornai, 1992)) and the market mechanism. In sharp contrast to the practice of capitalist economies in the world, the market socialism literature does not discuss the functions of financial markets. Market socialist thinkers (for example, Lange, Lerner, and Taylor) did not mention stock markets, although they all discussed product and labour markets in detail. Moreover, the role of law and legal institutions is absent in that literature as well.

A major reason for the sharp contrast in the different roles of financial markets and law in capitalist economies and in the market socialist economy literature is related to the ownership structures in the two models. Individuals in a capitalist economy not only trade products and labour, but also trade financial assets of means of production. Consistently, private ownership is the dominant ownership structure in a capitalist economy and financial markets are an essential part of a capitalist economy where ownership rights of means of production are traded. Associated with this, a legal mechanism is the key to protecting private property rights and to governing financial markets for exchanging financial assets. However, in principle, the dominant property right structure is state ownership in a market socialist economy.

Consequently, there is no need for financial markets as an institution for exchanges of productive assets. Moreover, as the state has an obligation to protect state properties and employs administrative power to enforce contracts, legal institutions designed to protect private property rights become redundant, or might even be in conflict with the will of the state bureaucracy.

Finally, the absence of stock markets in market socialism literature is also due to the fact that, at the time of the market socialist thinkers (for example, Lange, Taylor, Lerner), there was insufficient intellectual understanding of the function of stock markets and law as an essential mechanism for corporate governance. It was not generally recognized that there existed severe incentive problems in state-owned firms, and these problems were caused by the separation of ownership and control similar to that in publicly traded firms in capitalist economies. In fact, even in his later years, Lange still did not realize the importance of incentive problems associated with state-owned firms, although these issues were raised by von Hayek to challenge the market socialist idea. Many of the later leading proponents of market socialism did not realize the central importance of the incentive issue either (see a survey by Bergson, 1967). Thus, law and finance as mechanisms of solving those problems were unsurprisingly absent in the market socialism literature.

The Chinese government has claimed that its goal is to reform the Chinese economy into a market socialist economy. Although the coexistence of a large state sector and the increasingly dominant market forces makes the Chinese economic system appear similar to the features of market socialism in the literature, a basic fact might distinguish China from the literature: China has developed equity markets over the past decade on a large scale. However, in view of the fact that the Chinese stock markets are dominated by state-owned companies and are governed by an administrative mechanism, one could argue that these two features seem to fit well with the market socialism model.

Although China's equity market, under administrative governance, bears a resemblance to a market socialism model, we argue that the Chinese financial market development is actually inconsistent with a market socialist model. The dominant state ownership of listed companies is only a transitory phenomenon in China's economic transition. Listed state-owned companies are issuing progressively more equities to individual investors, introducing more private shareholders into state-controlled companies. More importantly, a general consensus or expectation among scholars and practitioners has been formed that as the Chinese securities markets develop further, the state-owned shares will ultimately become tradable, which allows private investors to acquire state-owned shares. Eventually the state will not hold controlling blocks for many of the listed firms and a substantial proportion of listed firms will be state-owned firms no longer. This implies a changing ownership pattern from the dominance of state ownership to that of private ownership. Thus, it contradicts the basic principle of market socialism.

How well, then, does the development of the Chinese financial market fit with a capitalist model? Extensive evidence has been reported on how markets work in capitalist economies. The literature shows that financial development determines economic development in market economies (King and Levine, 1993; Rajan and Zingales, 1998). From this perspective, it seems that the rapid financial and economic development in China fits well with that pattern. However, on the other hand, the literature also shows that the quality of law affects development of the financial market. In that respect, it does not seem that China fits with the capitalist model. In the literature, the quality of law is measured by formal minority shareholder rights (La Porta *et al.*, 1997; La Porta *et al.*, 1998), by formal mandatory disclosure rules and their enforcement (La Porta *et al.*, 2002), by the effectiveness of legal institutions (Pistor *et al.*, 2000), and also by the legacy of legal development in countries being studied (Berkowitz *et al.*, 2003). Failure of deterrence and regulatory failure are identified as means by which to understand how law and the related governance operate as important determinants for financial market development in capitalist economies (Pistor and Xu, 2003; Xu and Pistor, 2004). In contrast to the above facts, it has been noticed that China has poor formal legal institutions (Ohnesorg, 2003; Allen *et al.*, 2004; Pistor and Xu, 2005). China had a very weak legal basis when it began to develop financial markets in the early 1990s. Moreover, courts were weak, and have, in fact, played almost no role at all in enforcing investor rights to this day. Firm-specific information has been highly distorted, thereby undermining the effectiveness of newly established regulatory agents. Thus, if to follow the capitalist law and finance model – that is, to rely on legal governance – the Chinese attempts to jump start securities markets would suffer greatly from the severe problems experienced with deterrence and regulatory failure.

Explaining the Chinese financial governance approach, Pistor and Xu (2005) argue that China has deployed an administrative governance structure in their financial markets, which has mitigated deterrence and regulatory failure. Comparing this Chinese practice with the capitalist model, we argue that Chinese financial market governance does not fit with the 'typical' capitalist model. The anchor of the Chinese financial market governance institutions was the so-called 'quota system'. This system effectively enlisted pre-existing institutions of state and party governance in the selection of companies for listing on a stock exchange. It was based on the existing regional competition, and it created further competition among regions for access to centrally-controlled equity market entry. It tapped into insider knowledge about firms by state bureaucrats at companies and/or local governments, information that was not accessible by other means. Our evidence suggests that the quota system creates incentives for regional governments to select better firms. Specifically, the allocation of quotas to each region was determined by the earlier aggregate performance of the listed firms from the region. This implies that regional governments selecting better performing firms at initial public offerings (IPOs) in previous periods had been rewarded by gaining more quotas later; and vice versa. Moreover, our evidence from the cross-regional financial development shows that regional financial development (in equity markets) in China is positively correlated with levels of regional economic development and internationalization. That is, although different from the capitalist model of financial market governance, the cross-regional financial development under this Chinese structure is consistent with the trend of capitalist economies discovered in the cross-country studies (for example, Claessens *et al.*, 2002).

Finally, we conclude this chapter by arguing that, although the initial stage of jump starting stock markets in China has been successful, this administrative governance might not be a long-term solution for China's financial development. Thus, even purely from a structure of governance point of view, this cannot be regarded as a workable model of market socialism. Our evidence shows that the Chinese governance structure is failing to monitor companies once they are listed on the market, indicating that this Chinese administrative governance is not a stable system. Moreover, this administrative governance structure does not work effectively for non-state owned firms, which is a necessary condition in a capitalist model of financial market. Therefore, it is neither a stable market socialist model nor a stable capitalist system.

The rest of the chapter is organized as follows. The next section explains briefly the Chinese non-capitalistic financial market governance institution. We then go on to provide evidence as to how this institution works. The subsequent section demonstrates that Chinese regional financial development seems consistent with the pattern discovered from capitalist economies. The final section concludes that, although initially successful, the Chinese financial market governance structure is losing its effectiveness. Thus, it is only a transitional phenomenon.

Non-capitalistic governance of Chinese financial markets

Compared with a capitalistic financial market governance model, China's record of enforcement of public law is very weak and there is no record of private law enforcement. However, almost all standard measures for stock market performance suggest that China is performing better than most other transition economies, which are all adopting a capitalist model. Particularly, China has outperformed all other transition economies on what might be the most important aspect – the ability of listed firms to raise funds. China has the most liquid of all stock markets, with only Hungary coming close. Companies in Central and Eastern Europe have only rarely used IPOs to raise capital, except Poland with 47 IPOs between 1994 and 2001. By contrast, in the same period, there were 873 IPOs in China. Between 1998 and 2001 alone, China witnessed 414 IPOs, with firms raising a total of 508.6 billion RMB (or US$ 61.6 billion) (Pistor and Xu, 2005). Considering the size of the various economies, given that Poland is the best among all other transition economies, and comparing Poland with the best Chinese region of a similar size, the Chinese region outperforms Poland. That is, the qualitative result of the performance comparison above will not be changed.

Non-capitalistic governance or a weak legal institution on the one hand, and strong performance of jump starting the stock market on the other hand, make China a puzzling case. We argue that China's financial market development was based on an administrative governance regime, which partially substituted formal legal institutions and prevented the enforcement of the worst failures. The core of it was the so-called 'quota system'. The quota system was officially in place from 1993–2000. *De facto*, it governed financial markets up to the end of 2002 or later.

The quota system functioned to promote decentralized information collection in an environment that was plagued with information problems far exceeding those commonly known in developed financial markets. Investors, as well as regulators, face substantial obstacles to obtaining access to corporate information – particularly for companies that launch IPOs, as little information about them is known to the market. In Western markets, mandatory disclosure rules seek to reduce information problems. Conditions for the efficacy of mandatory disclosure rules, however, were not present in China. Under a centrally planned system, state-owned companies operated according to accounting standards that contained little information relevant for evaluating their market value. Even when books were converted by applying international accounting standards, the conversion process was subject to a substantial margin of error (Fang, 1995). Professional market watchdogs willing and able to verify accounts were only beginning to emerge and the creation of an effective governance structure for these intermediaries lagged even further behind. Absent effective governance, accountants, auditors, and securities analysts often participated in fraud (Green, 2003). Against this background, disclosure rules could not be credibly enforced and were therefore ineffective in resolving the severe information problem faced by investors and regulators. Instead, mechanisms were needed to induce insiders to reveal critical information that could be used for a meaningful selection of companies for public offerings.

Under the particular Chinese conditions, the quota system created an incentive structure that helped solve informational problems at the IPO stage. Regional competition has been essential in various reforms in China. That competition among regions has developed vested interests for regional government officials in their regions' economic performance, which became a critical factor for their own career advancement (Qian and Xu, 1993; Maskin, Qian and Xu, 2000). By rewarding better regional corporate performance with more quotas in share issuance for that region in subsequent periods, the quota system encouraged the local governments to bring the better performing firms in their regions to be listed on the stock market. Moreover, the quota system is believed to enhance efficiency because allowing regions with better corporate performance to issue more shares is largely equivalent to allowing regions with better economic performance to raise more equity finance. From the restoration of stock markets in the early 1990s until now, the performance of regional companies on the two major stock exchanges has been directly linked to the region's economic performance. Two factors contribute to this link. First, sources of funding sought by corporations for political reasons have diminished. The central credit allocations were curtailed and firms became less dependent on regional budgets. The allocation of funds has been driven more and more by considerations of efficiency. Second, more sources of non-state-administered corporate finance came into being. Listed companies gained access to equity finance where private investors play an important role; firms also obtain bank financing from other regions.

How administrative governance structure works: evidence

Quotas have been a basic feature of state and regional economic management in China prior to and during the transition period, in particular for allocating critical resources among regions.[1] The annual quota for each region was established in intense bargaining between regional governments and relevant central agencies (that is, the Ministry for Energy, or the Central Bank). The primary purpose for extending the quota system to China's fledging stock markets was to maintain control over its size and stability (Fang, 1995). In its practical application, however, it is related to the existing regional competition; and it created further regional competition for the allocation of quotas, which in turn fostered a selection and information collection process that facilitated market development during the crucial start-up period.

Each year, the People's Bank of China (PBoC) established the amount of shares firms were allowed to issue to the public. In 1993, the first year that the quota system was in full operation, 5 billion shares were made available at the national level. Individual regions received quotas in amounts of 50 million to 500 million shares (Fang, 1995). Governments at the provincial level negotiated the size of the quota for that region with the respective provincial branch of the China Securities Regulatory Commission (CSRC). When they reached an agreement, the request, together with information about the companies the province wanted to bring to the market, was submitted to the centre. The CSRC decided the allocation of quotas to different provinces and ministries on the basis of the information it had received and within the quantity constraint established by the PBoC. As we will further argue, this promoted competition among the regions and induced them to collect and reveal critical information about the relative quality of companies operating in each region.

After the regional quota had been allocated, the selected companies had to go through an individual approval process. At this stage, the applicants were vetted for compliance with the formal merit and disclosure requirements set forth in relevant statutes and regulations (Fang, 1995).

The quota system, de facto, served as an important administrative governance device, which consisted of incentives for decentralized collection of information. That limited serious fraud at the stage of IPO. Specifically, the quota system imposed a 'quantity constraint' to provinces. With competition among provinces, this created incentives for local governments to select companies that would enhance the province's future access to quotas. By involving regional governments as the owners of regional state-owned firms, the quota system also tapped into insiders' knowledge and thereby reduced the problem regarding information.

If the operation of the quota system provides incentives, we should observe that future allocations of quotas to a region are related to past performance of companies from that region. That is, quota allocations to regions should be positively correlated with past performance of listed companies from corresponding regions.

The quota allocated to each region is the total number of shares that region is allowed to issue. However, time series information about the size of the quota allocated to different regions is not publicly available. The proxy for the size of a region's quota that we use is the number of shares issued by firms from different provinces.[2] We use the rate of increase in the number of shares issued to control for the variation in the size of regions. To account for the time lag between the allocation of shares to a province and the actual public offering, we use changes over a three-year period. Specifically, the rate of increase in quota for region i at period t is measured as $[y(i,t)-y(i,t-3)]/y(i,t)$, where $y(i,t)$ is the total shares of region i in year t, where t ranges from 1995–2003 and i covers 31 Chinese provinces and provincial level municipalities.[3] To link the quota to the regional performance of listed companies, we employ several measures for the performance of listed companies as independent variables, which encompass indicators such as total and tradable market capitalization, price/book–value ratio, turnover ratio, and net profits, respectively. We also use the rate of increase in these variables over a three-year period in our regression analysis.

Specifically, performance indicators for listed companies from region i in period t includes the three-year growth rates of market capitalization of total tradable shares of listed companies, the market capitalization of tradable shares, the P/E ratio, the P/B ratio, the turnover ratio, the net profits and the earnings per share. In regressions, the performance indices are lagged by one year, that is, $[y(i,t-1)-y(i,t-4)]/y(i,t-4)$, where $y(i,t-1)$ and $y(i,t-4)$ are region i's performance in year $t-1$ and $t-4$ respectively. To save space, we report only two scatter plots to illustrate our regression results whereas the details of regression models and tables are omitted.

Figure 6.1 presents the scatter plot of the relationship between the earlier performance indicators and the subsequent quota allocation on the basis of the panel data of the two variables over the period 1995–2003. We can see that the earlier performance indicators, such as the growth in market capitalization of tradable shares and that in net profits, show strong positive correlations with the later quota allocation. Similar positive correlations can also be observed between later quota allocation and earlier performance measured by other aspects of market or accounting performance.

To present a broader picture between performance and quota allocation, we constructed performance indices of listed companies from

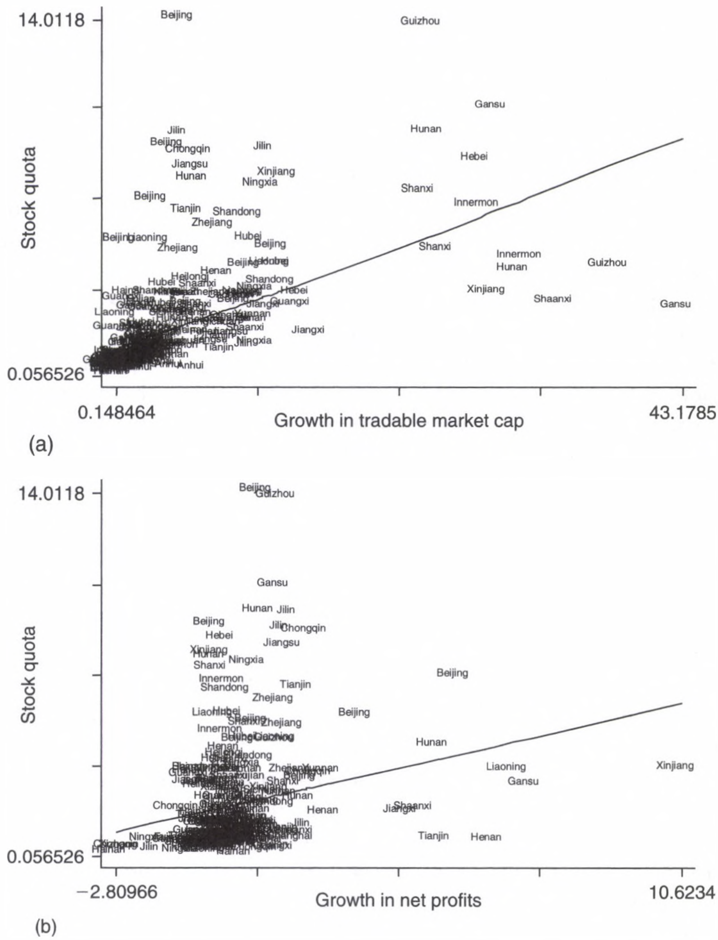


Figure 6.1 Stock quota v.: (a) growth in tradable market capitalization; (b) growth in net profits, 1995–2003

region *i* at period *t*. We group individual performance indicators into two broad categories. One group is based on stock market performance, while the other group is built on the accounting data. We thus construct three categories of indices in our two regression models:

1. *Overall performance index* This is constructed as the simple average of the three-year growth rates in market capitalization of listed

companies, the market capitalization of tradable shares, the P/E ratio, the P/B ratio, the turnover, the net profits and the earnings per share for each region;
2. *Market performance index* This is calculated as the simple average of the three-year growth rates in regional aggregate levels of market capitalization of total shares of listed companies, the market capitalization of tradable shares, the P/E ratio, the P/B ratio, and the turnover for each region;
3. *Accounting performance index* This is the simple average of the three-year growth rates in regional average levels of net profits and earnings per share.

In regressions, the performance indices are lagged by 1 year; that is, (regional performance in year $t-1$ minus regional performance in year $t-4$)/regional performance in year $t-4$.

From Figure 6.2, we can see that earlier overall performance and market performance indices exhibit fairly strong positive correlation with the later quota allocations based on the panel data over the period 1995–2003. The earlier accounting performance index also moves positively with the later quota allocations, though the correlation is weaker.

Although strong correlations between previous performance and later quota allocations suggest that performance determines quota allocation, statistically it does not completely rule out a reverse causality. To address this issue, we conduct some cross-section regressions based on the early stage of stock market development and quota allocation. The idea of this exercise is that when the stock market was initially established, it was much harder to imagine that initial quota allocation had any major impact on corporate performance.

The quota system was initiated in 1993, and only in 1994 and 1995 did most of the Chinese provinces (29 provinces) begin to have corporations listed in Shanghai or Shenzhen stock exchanges. The number of shares issued in these initial years reflects the initial allocation of quota for almost all provinces. It provides a starting point for us to analyse how the allocation of quotas in subsequent periods responds to regional variation in corporate performance. In other words, most provinces did not successfully put their firms onto the stock market until 1994 and 1995. After this, they ran a horse race to compete for quota allocation by presenting their better performing firms.

Focusing on the early stage of stock market launch, we examine how the quota allocation in the period 1995–98 responds to the changes in the provincial corporate performance indicators. Figure 6.3 (p. 100)

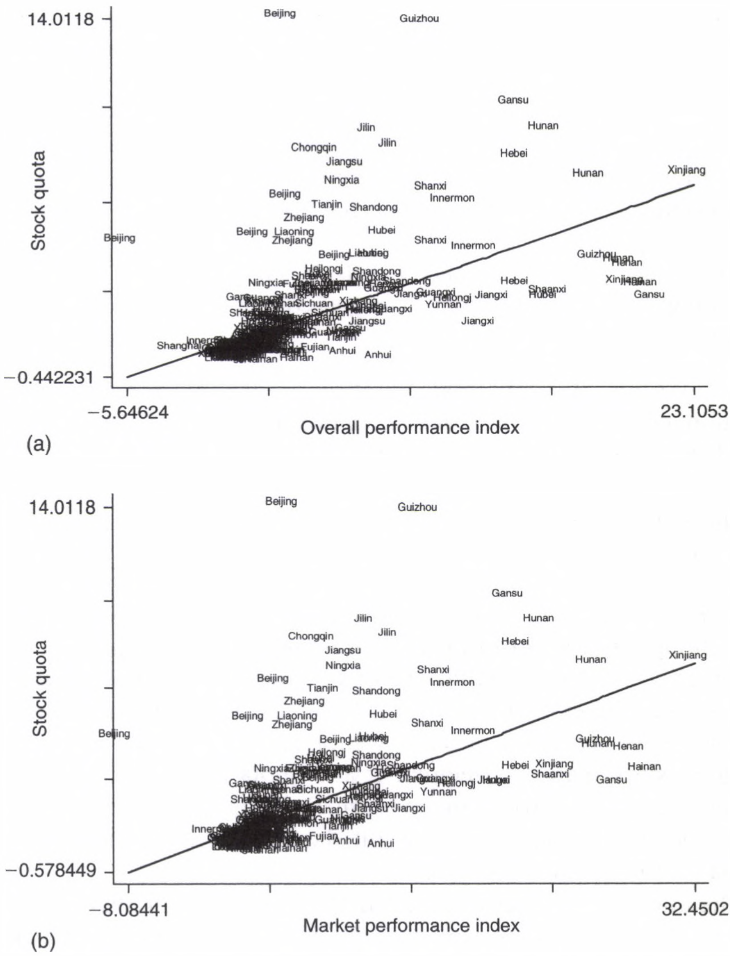
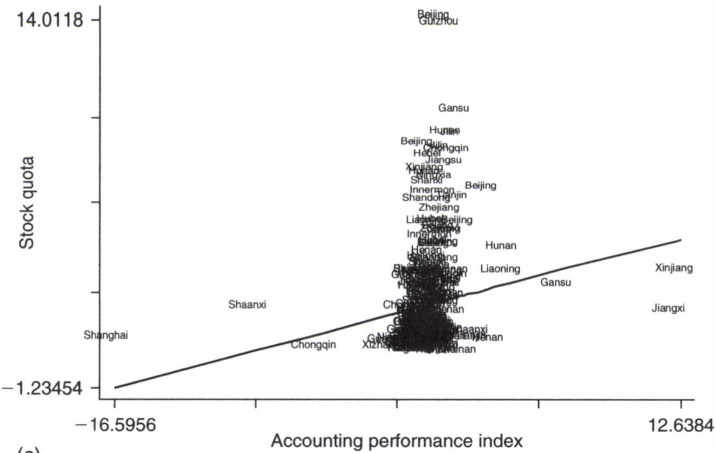


Figure 6.2 Stock quota v.: (a) overall performance index; (b) market performance index; (c) accounting performance index, 1995–2003

demonstrates cross-section regressions, where the dependent variable is the three-year growth rate in the total number of shares from 1995–98. The independent variables are growth rates in the performance indicators, such as growth rates of tradable market capitalization or of net profits over the period 1994–97. We see that all the individual performance indicators show a clear positive correlation with the subsequent growth in quota allocation.



(c)

Figure 6.2 (Continued)

In Figure 6.4 (p. 101), we present the relationship between the three aggregate performance indices and the later quota allocation based on the period 1995–98. Clearly, there is strong positive correlation between the two variables based on the cross-section regression.

Cross-region performance: capitalist economies v. Chinese economy

Evidence from the preceding section suggests that a non-capitalist governance approach seems to be working in Chinese financial market development; that is, the quota system was a de facto incentive scheme to motivate regional governments to select better firms at IPO stages. That is because regions with firms that perform better in the stock markets are more likely to acquire further quota allocation in the future. Then, it is natural that the non-capitalistic governance approach will affect regional financial development. An interesting consideration is in the direction in which the governance approach impacts the regional developments in China.

To address this question, we compare Chinese cross-region financial/economic development with the pattern discovered in the capitalist world. Cross-country studies from capitalist economies show that there is a strong positive correlation between financial development and economic development (for example, Claessens, *et al.*, 2002). Figure 6.5 plots

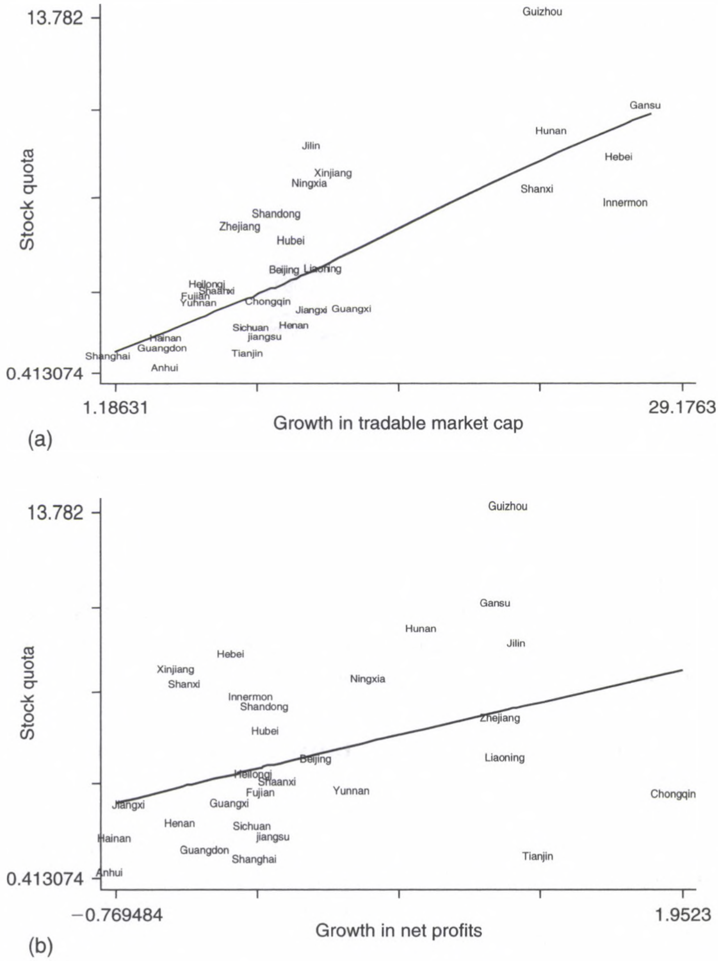


Figure 6.3 Stock quota v.: (a) growth in tradable market capitalization; (b) growth in net profits, 1995–98

regional (provincial) per capita GDP against regional market capitalization/GDP ratio in 2002. It suggests that, similar to cross-country results for capitalist economies, the Chinese regional distribution of the two indicators also show a strong positive correlation.

To gain further insight into the relationship between geographical distribution of quota and economic development, we group all provinces

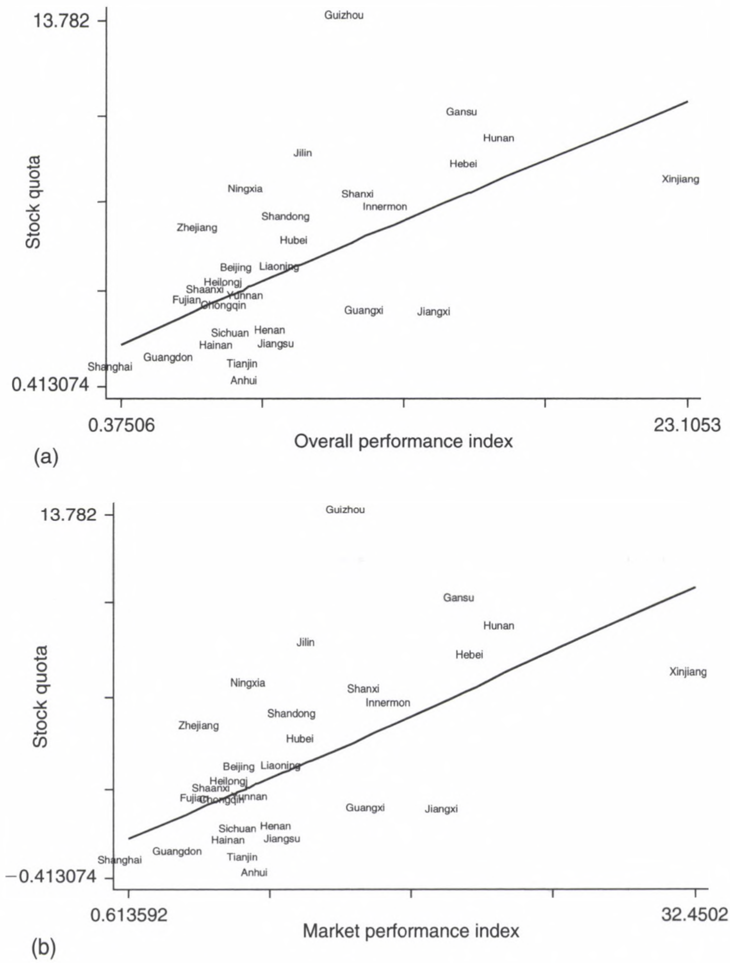
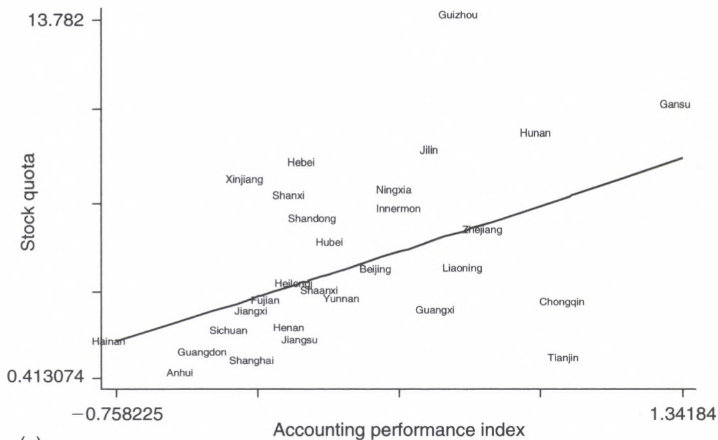


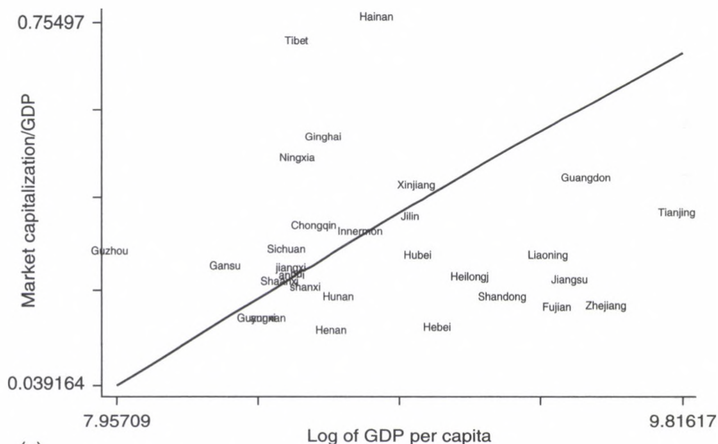
Figure 6.4 Stock quota v.: (a) overall performance index; (b) market performance index; (c) accounting performance index, 1995–98

and provincial-level municipalities into three broad regions: the east coast region, the central region, and the western region. The general consensus is that the socio-economic development level is the highest in the east coast region and declines gradually across the central and western regions. In Table 6.1, we present some summary statistics for the financial market development in the three broad regions in 1994 and 2002. The



(c)

Figure 6.4 (Continued)



(c)

Figure 6.5 GDP per capita v. market capitalization/GDP, 2002

indicators of financial development that we consider comprise market capitalization/GDP, tradable A-share market value/GDP, and aggregate market turnover ratio. Consistent with our expectation, the east coast region clearly enjoys a substantially higher level of financial development, registering a larger value of these three indicators than the central and western regions in the year 1994. Though the gap shrinks in 2002,

Table 6.1 Summary statistics of the ratios of: market capitalization over GDP; tradable A-share market value over GDP; and aggregate market turnover ratio, 1994 and 2002

			1994			
		Market	**Cap/**	**GDP**	**Ratio**	**(%)**
	No. obs	Mean	Median	Max.	Min.	Std dev.
East-coast region	11	0.16	0.021	1.14	0.0098	0.33
Middle region	8	0.029	0.021	0.098	0.0059	0.029
Western region	9	0.021	0.016	0.043	0.0070	0.013
		Tradable	**A-share**	**Market**	**Value/GDP**	**(%)**
	No. obs	Mean	Median	Max.	Min.	Std dev.
East-coast region	11	0.031	0.0080	0.15	0.0017	0.047
Middle region	8	0.0066	0.0063	0.012	0.0023	0.0042
Western region	9	0.0067	0.0044	0.015	0.0021	0.0052
		Aggregate	**Market**	**Turnover**	**Ratio**	**(%)**
	No. obs	Mean	Median	Max.	Min.	Std dev.
East-coast region	11	20156.45	8263.84	115231.80	2651.04	33116.25
Middle region	8	3414.79	2350.12	8034.55	618.03	2677.17
Western region	10	3604.70	1657.50	14839.64	848.64	4361.98
			2002			
		Market	**Cap/**	**GDP**	**Ratio**	**(%)**
	No. obs	Mean	Median	Max.	Min.	Std dev.
East-coast region	11	0.54	0.27	1.82	0.14	0.57
Middle region	8	0.23	0.23	0.36	0.13	0.065
Western region	12	0.34	0.30	0.71	0.16	0.16
		Tradable	**A-share**	**Market**	**Value/GDP**	**(%)**
	No. obs	Mean	Median	Max.	Min.	Std dev.
East-coast region	11	0.14	0.091	0.34	0.044	0.024
Middle region	8	0.082	0.082	0.13	0.043	0.064
Western region	12	0.13	0.11	0.27	0.053	0.064
		Aggregate	**Market**	**Turnover**	**Ratio**	**(%)**
	No. obs	Mean	Median	Max.	Min.	Std dev.
East-coast region	11	13627.51	11928.5	35178.16	3769.87	10294.74
Middle region	8	6804.95	6799.63	11333.79	2866.84	2355.79
Western region	12	4466.93	3336.35	13177.62	1930.96	3059.26

Note: The series are averages across provinces that are grouped into three regions – the east coast region, the central region, and the western region. East coast region includes Beijing, Fujian, Guangdong, Hainan, Hebei, Jiangsu, Liaoning, Shandong, Shanghai, Tianjin, and Zhejiang. Provinces such as Anhui, Heilongjiang, Henan, Hubei, Hunan, Jiangxi, Jilin, and Shanxi are classified into the central region. The western region encompasses Chongqing, Gansu, Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Xizang (Tibet), Xinjiang, and Yunnan. (Guangxi and Inner Mongolia are centrally located, but they participate in western development scheme.)

Source: Authors' calculation based on data from the Shanghai WIND database for China's listed companies.

the east coast region still claims the highest value of these three indicators of financial market development. However, there is no clear difference in the level of financial development between the central and the western regions. This is probably because the east coast region leads the nation in stock market development and corporatization, while both the central and western regions are lagging behind and are at similar levels.

Conclusion

Our analysis of the quota system as an alternative governance device to allow *ex ante* screening in an environment that is hampered by lack of information and effective *ex post* law enforcement does not account for how markets were governed in the post-listing stage. It is becoming increasingly clear that the quota system is ill suited for dealing with problems of continuous disclosure or market manipulation. Moreover, the CSRC is not well placed to use law enforcement mechanisms against companies that have total backing from the regional authorities, because even though it is a central government agency, it does not have formal supervision over provincial governments. In the public offering stage, this was less of a problem, because the CSRC could play regions off against each other and thus leverage on the fact that regions were competing with each other. However, these governance devices are significantly weaker in the post-listing world.

Violations by firms that have been already listed have become rampant in recent years. Summarizing data collected by the CSRC, Table 6.2 indicates that more than 90 per cent of all violations by firms listed in the Shanghai and Shenzhen Stock Exchanges were related to violation of continuous – that is, post-listing – disclosure, of which 64 per cent concerned violations of *ad hoc* disclosure requirements.

The ineffectiveness of the governance mechanisms based on *ex ante* screening for stemming violations that occur in the post-listing stage is corroborated by data on the regional distribution of violations (Table 6.3). Interestingly, the best performing regions – Northern China, Eastern China, and Southern China – are on opposite ends of the spectrum, suggesting that the post-listing violations are independent of economic performance. The number of listed firms from Northern and Eastern China accounted for more than 56 per cent of all listed firms in the two stock exchanges, whereas their violations amounted to less than 31 per cent of all violations. This seems to suggest that better performance is associated with greater compliance, or less cheating. By contrast, the data on Southern China suggest the opposite.

Table 6.2 Violations on Shanghai and Shenzhen stock exchanges, 1993–2001

	Type of Information	Type of disclosure violation	No. of violations	Share as % of total	Share as % of total
Violation of disclosure requirements at public offering	IPO	False information disclosure re: listing	9	3.6	4.0
	Stocks distributed to employees	False information disclosure re: employee-held shares	1	0.4	
Violation of continuous disclosure requirements	Periodic disclosure (annual report)	Non-disclosure in annual report	34	13.6	28.8
		False disclosure in annual report	14	5.6	
		Other annual report disclosure violations	24	9.6	
	Periodic disclosure (mid-year report)	Non-disclosure in mid-year report	3	1.2	4.0
		False disclosure in mid-year report	7	2.8	
	Interim information disclosure	M&A information disclosure	2	0.8	58.8
		Non-disclosure of major investments	3	1.2	
		Non-disclosure of guarantees	12	4.8	
		Non-disclosure of major transactions	13	5.2	
		Non-disclosure of major litigations	15	6.0	
		Non-disclosure of connected (related) transactions	18	7.2	
		Non-disclosure of predicted losses	31	12.4	
		Unapproved interim disclosures	3	1.2	
		False interim information disclosure	1	0.4	
		Failure to make interim disclosure	49	19.6	
Others	Other reasons	Other reasons	11	4.4	4.4
	Total		250	100	100

Source: He Jia *et al*. (2002).

Table 6.3 Regional distribution of listed companies penalized for disclosure violations

Regions and provinces within them	No. of firms fined	Firms fined (%)	No. of firms listed (% of national total)	Violation indicator
North east Heilongjiang, Jilin, Liaoning	31	14.22	10.51	+35.30
Northern China Beijing, Tianjin, Inner Mongolia, Hebei, Shanxi, Shandong	22	10.09	17.98	−43.87
Eastern China Shanghai, Anhui, Zheijiang, Fujian, Jiangsu, Jianxi	47	21.56	28.58	−24.56
Southern China Guangdong, Guangxi, Hainan	62	28.44	15.38	+84.92
Central China Henan, Hunan, Hubei	25	11.47	9.99	+14.79
North west Shaanxi, Gansu, Ningxia, Qinghai, Xingjiang	6	2.75	6.69	−58.86
South west Changqing, Yunnan, Guizhou, Sichuan, Tibet	25	11.47	10.86	+5.86
TOTAL	218	100	100	0

Source: He Jia *et al.* (2002).

Only 15 per cent of listed firms are located in the Southern region of China, but they accounted for 28 per cent of all violations – the worst region in the nation.[4]

Our chapter demonstrates that although the initial stage of jump-starting stock markets in China can be seen as a success, this administrative governance might not be a long-term solution for China's financial development. Thus, even purely from governance structure point of view, this cannot be regarded as a workable model of market socialism. Our evidence shows that the Chinese governance structure is failing to monitor companies once they are listed on the market: therefore, Chinese administrative governance will not be a stable system. Moreover, this administrative governance structure does not work effectively for non-state owned firms: therefore, it is neither a stable market socialist model nor a stable capitalist system.

Notes

* We thank Katharina Pistor for insightful discussions, Zhigang Tao, Kai Yuen Tsui and participants at the IEA Round Table for helpful comments. Special thanks also to the Shanghai Wind Information Co. for allowing us to use their China stock market dataset. We acknowledge financial support from the ESRC under the World Economy and Finance Research Programme (Award RES-156-25-0009). Part of the research was supported by an earmarked research grant (CUHK4112/04H) from the Research Council of the Hong Kong Government.

1. For the purpose of this chapter, we use the term 'region' to refer to administrative sub-divisions at the provincial level.
2. In reality, there is usually a time lag between quota allocation and the listing of a firm.
3. If we stretch the beginning year of the sample to 1994 or 1993, the calculation of the quota requires data on shares issued in year 1991 or 1990. However, very few provinces were allowed to put firms onto the stock exchanges at that time so that we cannot conduct meaningful statistical analysis.
4. The fact that Northern, Eastern, and Southern China are the best-performing economic regions is supported by other sources of data, such as the *Chinese Statistic Yearbook* (all years since the mid-1990s). The fact that Northern and Eastern China are among the regions that followed the law more closely (or are the least corrupt), and that Southern China is among regions that did not follow the law well (or are the most corrupt) is also supported by other sources of data, such as Xie and Lu (2003).

References

Allen, Franklin; Qian, Jun and Qian, Meiun (2005) 'Law, Finance, and Economic Growth in China', *Journal of Financial Economics*, 77: 57–116.

Bai, Chong-en; Liu, Qiao and Frank Song, Frank (2002) 'Value of Corporate Control: Evidence from China's Distressed Firms', Unpublished mimeo, Hong Kong University.

Bailey, Michael (1995) 'Accounting in Transition in the Transitional Economy', *European Accounting Review*, 4(4): 595–623.

Beck, Thorston and Ross Levine (2004) 'Stock Markets, Banks, and Growth: Panel Evidence', *Journal of Banking and Finance*, 28: 423–42.

Berglöf, Erik and Anete Pajuste (2003) 'Emerging Owners, Eclipsing Markets?', in *Corporate Governance and Capital Flows in a Global Economy*, Cornelius, P. and Kogut, B. (eds) (Oxford: Oxford University Press).

Bergson, Abram (1967) 'Market Socialism Revisited', *Journal of Political Economy*, 75(5), October: 655–73.

Berkowitz, Daniel; Katharina Pistor and Jean-François Richard (2003) 'Economic Development, Legality and the Transplant Effect', *European Economic Review*, 47(1): 165–95.

Chen, Zhiwu (2003) 'Capital Markets and Legal Development: The China Case', *China Economic Review*, 14: 451–72.

Claessens, Stijn; Klingebiel, Daniela and Schmukler, Sergio L. (2002) 'The Future of Stock Exchanges: Determinants and Prospects', *European Business Organization Law Review*, 3(2): 403–38.
Coffee, Jack C. Jr (1999) 'Privatization and Corporate Governance: The Lessons from Securities Market Failure', *Journal of Corporation Law*, 25: 1–39.
Coffee, John Jr (2003) 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms', Columbia Law and Economics Working Paper 237.
Fang, Liufang (1995) 'China's Corporatization Experiment', *Duke Journal of Comparative and International Law*, 5: 149–269.
Feenstra, Robert and Hanson, Gordon (2002) 'Ownership and Control in Outsourcing to China', NBER Working Paper.
Glaeser, Edward; Johnson, Simon and Shleifer, Andrei (2001) 'Coase vs. Coasians', *Quarterly Journal of Economics*, 116(3): 853–99.
Granick, David (1990) *Chinese State Enterprises: A Regional Property Rights Analysis* (Chicago: Chicago University Press).
Green, Stephen (2003) *China's Stockmarket* (London: Economist).
Green, Stephen and He Ming (2004) 'China's Stock Market: Out of the Valley in 2004?', *Royal Institute of International Affairs Briefing Paper*, February, 1: 1–11.
He Jia *et al.* (2002) *Chinese and Foreign Disclosure Systems Comparison and Their Effectiveness* (*Zhong-wai Xinxi Pilu Zhidu jiqi Shiji Xiaoguo Bijiao Yanjou*) (Shenzhen Stock Exchange Research Institute): table 3.5.
Huang, Yasheng (1996) *Inflation and Investment Controls in China* (Cambridge: Cambridge University Press).
Johnson, Simon; Boone, Peter; Breach, Alasdair and Friedman, Eric (2000) 'Corporate Governance in the Asian Financial Crisis 1997–98', *Journal of Financial Economics*, 58: 141.
Johnson, Simon; Glaeser, Edward and Shleifer, Andrei (2001) 'Coase vs. Coasians', *Quarterly Journal of Economics*. 116(3): 853–99.
King, Robert and Levine, Ross (1993) 'Finance and Growth: Schumpeter Might Be Right', *Quarterly Journal of Economics*, 108, 717–37.
Kornai, Janos (1992) *The Socialist System: The Political Economy of Communism* (London: Oxford University Press).
La Porta, R.; Lopez-de-Silanes, Florencio; Vishny, Robert and Shleifer, Andrei (2002) 'Investor Protection and Corporate Valuation', *Journal of Finance*, 57(3): 1147–70.
La Porta, Rafael; Lopez-de-Silanes, Florencio and Shleifer, Andrei (2004) 'What Works in Securities Laws?', Unpublished mimeo, Harvard University.
La Porta, Rafael; Lopez-de-Silanes, Florencio; Shleifer, Andrei and Vishny, Robert W. (1997) 'Legal Determinants of External Finance', *Journal of Finance*, 52(3): 1131–50.
La Porta, Rafael; Lopez-de-Silanes, Florencio; Shleifer, Andrei and Vishny, Robert W. (1998) 'Law and Finance', *Journal of Political Economy*, 106(6): 1113–55.
Lange, Oskar R. (1936) 'On the Economic Theory of Socialism: Part One', *Review of Economic Studies*, 4(1), October: 53–71.
Lange, Oskar R. (1937) 'On the Economic Theory of Socialism: Part Two', *Review of Economic Studies*, 4(2), February: 123–42.
Lerner, Abba (1947) *The Economics of Control: Principles of Welfare Economics* (New York: Macmillan).
Levine, Ross and Zervos, Sara (1998) 'Stock Markets, Banks, and Economic Growth', *American Economic Review*, 88(3): 537–58.

Lubman, Stanley (1995) 'Introduction: The Future of Chinese Law', *China Quarterly* 141, March: 1–21.

Maddison, Angus (2003) *The World Economy –Historical Statistics* (Paris: OECD).

Magida, Daniel (2003) 'Establishing an Effective Regulatory Regime: Corporate and Securities Case Studies from Russia and China', Mimeo, Columbia Law School.

Maskin, Eric; Yingyi Qian and Xu Chenggang (2000) 'Incentives, Scale Economies, and Organizational Form', *Review of Economic Studies*, 67(2): 359–78.

Morck, Randall; Yeung, Bernard and Yu, Wayne (1999) 'The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?', *ssrn.com*

Naughton, Barry (1996) *Growing Out of The Plan* (Cambridge: Cambridge University Press).

National Bureau of Statistics of China (various years) *Chinese Statistical Yearbook* (Beijing: China Statistics Publishing House).

Ohnesorge, John K. M. (2003) 'China's Economic Transition and the New Legal Origins Literature', *China Economic Review*, 14: 485– 93.

Pajuste, Anete (2002) 'Corporate Governance and Stock Market Performance in Central and Eastern Europe', *ssrn.com*

Pistor, Katharina; Raiser, Martin and Gelfer, Stanislav (2000) 'Law and Finance in Transition Economies', *Economics of Transition*, 8(2): 325–68.

Pistor, Katharina and Xu, Chenggang (2004) 'Incomplete Law', *Journal of International Law and Politics*, 35(4): 931–1013.

Pistor, Katharina and Xu, Chenggang (2005) 'Governing Stock Markets in Transition Economies Lessons from China', *American Law and Economics Review*, 7(1): 184–210.

Qian, Yingyi and Xu, Chenggang (1993) 'Why China's Economic Reforms Differ: The M-Form Hierarchy and Entry/Expansion of the Non-State Sector', *Economics of Transition*, 1(2): 135–70

Rajan, Raghuram and Zingales, Luigi (1998) 'Financial Dependence and Growth', *American Economic Review*, 88: 559–86.

Standard & Poors (2003) *Stock Market Factbook*.

Stigler, George J. (1961) 'The Economics of Information', *Journal of Political Economy*, 69(3): 213–25.

Taylor, Fred M. (1929) 'The Guidance of Production in a Socialist State', *American Economic Review*, 19(1): 1–8.

Walter, Carl E., and Howie, Fraser J.T. (2003) *Privatizing China: The Stock Markets and Their Role in Corporate Reform* (Hoboken, NJ: John Wiley & Sons (Asia) Pte Ltd).

Wang, Guiguo (1994) 'China's Company Law: The New Legislation', in *China's Company Law: The New Legislation* (Hong Kong: Butterworth).

Wong, Christine, P. (1991) 'Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China', *China Quarterly*, December, 136: 691–715.

Xie, Ping and Lu Lei (2003) *The Economics of Corruption in China's Financial Institutions: Behavior and Mechanism Design* (Beijing: People's Bank of China).

Xu, Chenggang and Pistor, Katharina (2004) 'Enforcement Failure under Incomplete Law', Mimeo, London School of Economics.

Zhu, Sanzhu (2000) *Securities Regulation in China* (Ardsley, New York: Transnational Publishers Inc.).

7

China's Path-Dependent Transition: Culture Mediating between Market and Socialism

Carsten Herrmann-Pillath

Beyond socialism and the market: economic culture as a real type

China's recent transition performance raises many questions about standard assumptions of economics. Most of these are related to the disturbing fact that a socialist political system hosts one of the most dynamic economies in world history. Economists solve this puzzle by different solution strategies, mostly ones gyrating around the so-called 'gradualism' controversy.[1] In this chapter, I wish to present a follow-up of my 1994 study (Herrmann-Pillath, 1994) in which I attempted a solution to the puzzle that focused on the costs of transition in terms of the individual and collective learning processes that become necessary to adapt individual behaviour to a new institutional framework. I posit that social learning is the core process in transition, and that this is strongly influenced by cultural factors. The analytical foundation for understanding this mechanism is path-dependence.[2]

In this chapter, I will show that the concept of economic culture is a much more powerful analytical device with which to understand Chinese realities because it goes back on a real-typical approach to the taxonomy of economic systems.[3] Economic culture helps to explain why, in China, certain system elements of socialism and a market economy can coexist and produce a viable institutional structure over a certain period of time that extends into the future. 'Market and socialism' is not a 'third way' in a sense of denoting a special kind of economic system independent from time and space (that is, ideal typical 'market socialism') but, rather, is a combination of particular properties of institutions that is contingent in space and time and viable during a certain period. In this sense, China is in a state of never-ending transition, but no longer a transition economy (in a similar vein, see Kennedy, 2003).

The task of this chapter is not only to improve our understanding of Chinese realities, but also to draw some theoretical conclusions from the Chinese experience. Thus, I put much emphasis on theory, to which the first part of the chapter is devoted. I sketch the analytical relation between path-dependence and culture. The second part of the chapter applies the resulting methodology to a particular aspect of Chinese transition; that is, property rights in rural China, taking land ownership and rural industry as two empirical cases.

The concept of culture: path-dependence and the cognitive embeddedness of institutions

Three types of path-dependence and the gradualism/'big bang' controversy

Path-dependence is one of the central buzzwords in claims about the historicity of economic change (Arthur, 1994). Sometimes, both ideas are simply equated; that is, path-dependence would simply mean historicity, which is seriously misleading because historicity is a much broader concept. The term 'historicity' denotes the singularity of trajectories of change that might result from the singularity of events that are usually treated as random shocks in economic models. Yet, the concept of randomness is too weak as it presupposes a closed space of possible events and, hence, a probability distribution. The essence of historicity, in general, lies in the singularity of events in an open and evolving space of possible states of the world. Historicity and true uncertainty are two sides of the same coin (North, 2005). In the context of general economic models, this includes all sets of exogenous determinants that are unique to the case in point. Further, on the phenomenological level singularity can be a property of events on a very different scale, such as structural properties of economic systems on the one hand and 'small' triggering events such as the role of single change agents on the other.

However, this kind of historicity does not imply that past states of the system determine its direction of change in the present. It only results in the need to link up general hypotheses about systems dynamics with a descriptive account of the time sequence of singular events. This, indeed, gives rise to a singular character for the entire process but does not yet imply that the system is non-ergodic. Path-dependence is a much more specific form of singularity, which relates to the non-ergodic nature of the systems processes.

Path-dependence arises from the continuing causal relevance of past states on present states in frequency-dependent processes. Dealing with institutions, there are three different causal channels (this follows Ackermann, 2001):

Type A path-dependence

Frequency-dependent processes, in the strict meaning of the term, occur if there is an interaction between individual decisions and the distribution of different behavioural patterns in a population, such that critical-mass effects occur (cf. Witt, 1989). History becomes a binding force here because, first, the attainment of critical masses might depend on contingent starting events and, second, because in later states any change of the *status quo* requires the build-up of critical masses for alternative behavioural patterns.

Type B path-dependence

This results from the interaction among institutions that show related characteristics, in a similar vein to network externalities in communication systems (cf. Aoki, 2001: ch. 8). That is, there are complementarities in institutions that restrict the scope for change of single institutions. Thus, historicity reflects the singularity of network configurations of institutions that might have arisen from singular events in the past, but which continue to exert systematic forces on the direction of change in the present.

Type C path-dependence

The third kind of path-dependence emerges from the interaction of types A and B path-dependence. Frequency-dependence of individual actions often presupposes a cognitive representation of the pertinent property of the population; that is, the observation of the distribution of frequencies. This is mediated via cognitive models of institutions and configurations of institutions. In that case, institutions become internalized, such that institutional change is necessarily a process of social learning (Mantzavinos, 2001).

I summarize the brief systematics of path-dependence in Table 7.1. The important conclusion to draw is that to understand real-world change, the interaction between the different types of path-dependence and singularity should be recognized as the main cause of the complexity of history, which also renders empirical research an onerous endeavour.

Referring to this understanding of historicity, it is relatively easy to explain the potential persistence of suboptimal institutions, similar to

Table 7.1 Causality and history

Historicity ('history matters')	
Path dependence • *Type A*: frequency-dependence and critical mass effects • *Type B*: Network effects and institutional complementarity • *Type C*: Dualism of institutions and cognition	**Singularity** in multi-level systems with open state spaces and novelty
Dynamics Singular events trigger path dependent processes Type A–PD interact*	

*PD: path dependence.

the persistence of less than optimal technologies in terms of 'lock-ins'. What is more difficult is to explain is why 'inefficient' institutions might persist, because they possibly produce a positive outcome that could reinforce the 'inefficient' institutions, even though they are identified as 'inefficient' according to some benchmarks. This constellation can only occur if the behavioural effects of institutions are context-dependent – in particular, dependent on the cognitive models, so that there is no context-free measure of efficiency. In recent experimental economics, these have been labelled as 'framing' effects. Framing effects imply that the incentives resulting from particular institutions can no longer be analysed with the help of a universal rational choice model.[4]

In the current uses of path-dependence, this is related to the Panglossian problem that pops up if we take all pertinent categories of costs of institutional change into consideration and argue in terms of a total politico-economic equilibrium. In this case, the observer is no longer able to evaluate institutions according to some external vantage point.[5] That is to say, if an inefficient institution cannot be abrogated because of relatively high costs of change, this itself can be regarded as an efficient state. If the costs of change depend on contingent cognitive models, any external measure of costs of change would need to include an objective standard for measuring individual costs of learning. As these are not independent from the interactions among the members of a population, we reach the conclusion that measures of efficiency are themselves path-dependent, at least under certain circumstances (Binger and Hoffman, 1989). In other words, once the costs of institutional change are themselves dependent on the distribution of mental models in a population,

Table 7.2 Path dependence and efficiency

External measures of efficiency	**Internal measures of efficiency**
Commensurable across sets of external observers	Only commensurable within given politico-economic systems
Systems competition: GDP, export performance, employment, etc.	Politico-economic measures: Learning costs, balance of interest groups, subjective welfare and distribution/loss aversion
Types A and B path dependence: Institutional change independent of cognitive models **'Big bang' feasible**	**Type C path dependence:** Strong interaction between cognitive models and institutional change **Gradualism feasible**

path-dependence might occur on the levels of both the institutions and the cognitive models.

As we see from Table 7.2 above, the path-dependence of measures of efficiency is directly relevant for the controversy over gradualism. Advocates of a 'big bang' implicitly refer to path-dependence of types A and B:

- First, they assume that institutional change is frequency-dependent and so small steps of change might never arrive at a fully-fledged systemic change because critical masses are not achieved.
- Second, if institutions are correlated with each other, only a systemic approach can achieve institutional change.

From this comes the conclusion that a 'big bang' is needed to push a system beyond the fetters of path-dependence. This is related to an ideal-typical distribution of objective costs of transition, because a 'big bang' leads to a sudden change of the value of assets with a very strong need for reallocation, such that the economy first needs to cross a valley of tears with low growth rates until achieving a new regime with high growth rates (cf. Blanchard and Kremer, 1997).

Thus, path-dependence can only serve as a justification of gradualism (as well as an explanation of the success of gradualist policies) provided we deal with the third phenomenon; namely, the interaction between institutional change and social learning. In this case, the crucial question is whether any exogenous systemic change can immediately affect the internal cognitive models in such a way that the new cognitive models support the external institutions. A 'big bang' might fail to hit the target if the newly implemented institutions are undermined by behavioural patterns that still follow old cognitive models.[6] The decisive observation here is the network property of cognition, which implies that those effects may arise even if the single institutions are related to 'correct' single models. Yet these are embedded in another system of models that alters the expected effects of the institutions. This situation gives rise to high costs of learning, so that gradualism might be the more efficient solution because the costs of learning are lower. Thus, in the third scenario the network effects of cognition are decisive for the emergence of path-dependence. Because of this elevated importance, I wish to give them a new, yet very familiar name; that is, 'culture'.

The analytical approach to culture: cognitive path-dependence

In the modern applications of the concept of 'culture', culture is related to cognitive phenomena (DiMaggio, 1997; Strauss and Quinn, 1997). This is important in order to distinguish culture from institutional phenomena – in particular, from informal institutions. To put it simply, institutions are external to the individual, cognitive phenomena are internal. For example, an institution is supported by an external sanctioning mechanism, whereas behaviour steered by cognition is driven by internal factors. Both are related to each other as cognitive models actually shape the perception of external incentives.

The distinction between cognitive models and institutions is the precondition for the analysis of the third kind of path-dependence. The concept of culture is crucial to understanding the phenomenon of cognitive linkages between different cognitive models, which gives rise to cognitive path-dependence.

In a first approximation, culture is defined as a pattern of cognitive models that is stable in time. More exactly, 'culture' denotes path-dependence of cognition that results from type C path-dependence if the evolution of cognitive schemes itself manifests path-dependencies of all three types, with network effects among cognitive models being of particular importance. This implies that past states of the cognitive system impact on its present states. Network effects occur both on the individual level and the collective level, because cognitive models also need to be coordinated via communication between actors. Thus, culture is one of the main causes of the historicity of institutional change.

To this we add that culture is a concept that also relates to the pattern recognition by the observer of institutional change; that is, it is 'observed path-dependence'. Observation takes place internally and externally to the population that is the object of scrutiny. This is a very important analytical ingredient of any advanced theory of culture, because it highlights the 'gestalt' feature of culture and, hence, the role of human cultural creativity (cf. Schlicht, 1998). Internal, participating actors observe path-dependence of cognitive change and construct cognitive models of culture, in this way self-observation becomes an independent network effect potentially leveraging cultural path-dependence. These internal observations might be related to observations made by external actors, who articulate their perceptions within a different network of cognitive models. Intercultural communication brings these two observations into contact with each other, which requires translations of meanings (Ingold, 1993).

Hence, a crucial role in maintaining cultural stability is played by path-dependent systems of meaning:

- First, configurations of cognitive models refer to common meanings of single constituents of the models. These common meanings are the essence of culture, in that cultural analysis can never proceed on the level of single models and related institutions.
- Second, cultural change needs to preserve certain points of contact in changing meanings through time, because otherwise a loss of meaning will occur, which can result in a state of anomie.
- Third, cultural meaning is a primordial force in inter-subjective communication, in that success/failure to communicate channel the changes of meaning, giving cultural change a particular direction that links up past collective meanings with present conceptual innovation of individuals.

In terms of our three kinds of path-dependence, cultural path-dependence presupposes a mechanism of how subjective meanings are actually linked up with each other. This is communication, as opposed to direct interaction between observed behaviours. Observation of behaviour is dependent on cognitive models, in that there is a potential frequency-dependence on two different levels; namely, the behaviour itself and the communication relating to that behaviour. In a similar vein, networks of cognitive models are reinforced if, during communication, meanings of the sender are fitted into existing meanings of the receiver.[7]

Thus, cultural change is a process that works through the self-application of cognitive models, both on the subjective and the inter-subjective levels. In this context, it is of particular importance to analyse cross-cultural interactions of meaning. So far, our use of culture is by no means identical to familiar interpretations of that idea that assign the concept to ethnic groups, however defined. Still, conventional boundaries of this type are important insofar as they are, in most cases, also boundaries between linguistic communities. Language is the most fundamental carrier of meaning. Very often, cultures are reinforced by certain conventions in cross-cultural communication that are linguistically mediated. This is the common use of 'culture'. For example, people might agree that China is called, and can call herself, a 'Confucian culture', and this message might be even politically supported by appropriate cultural policies. Evidently, our concept of culture is a far cry from that. In our view, 'Confucianism' might be a shorthand description of certain complex interactions among institutions and cognitive models, but it is not a cultural category in the analytical sense, unless it can be shown that 'Confucianism' is indeed a cognitive model that feeds back on the path-dependence of institutional change.

In conclusion, we arrive at a very complex picture of the path-dependence of institutions, one that goes far beyond the simple effects of frequency-dependence. Once economists acknowledge the cognitive determinants of institutions, culture becomes a core analytical category.

Methodological consequences

Figure 7.1 summarizes our previous analysis. Our perspective on institutional change implies that there are two fundamental forces working together: institutional design and culture. In the gradualism debate, the protagonists of the 'big bang' presume that institutional design can be the dominant force in determining institutional change. Every political

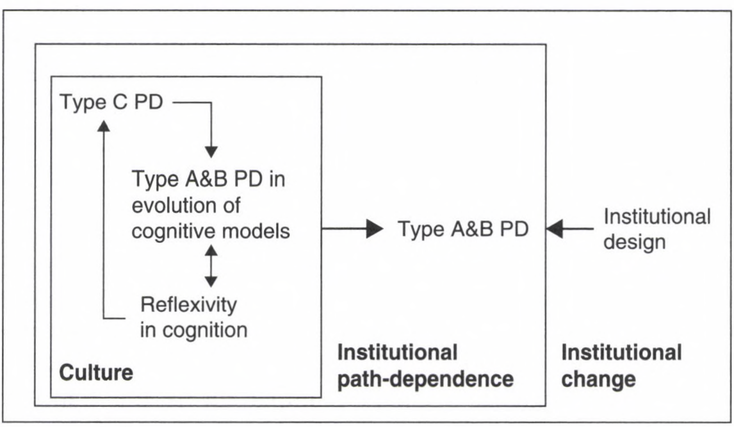


Figure 7.1 Institutional design and culture

act aimed at establishing a new institution can – but need not always and everywhere – meet the countervailing force of type A and B path-dependencies. Institutional design can overcome those forces if it is sufficiently comprehensive and autonomous in the sense of political commitment to the political goals. However, type C path-dependence can also be at work behind those forces. The interaction between cognition and institutions can also be the object of political manipulation; however, this is a much more complex and difficult kind of action, as it is related to the ideological and communicative transmission of policies.

In some cases, beyond type C path-dependence there can be the additional impact of culture; that is, cognitive path-dependence. Cognitive path-dependence results from the interaction between type C path-dependence and type A and B path-dependencies on the level of the cognitive models themselves. This is reflected in communication over cognitive models in the population that are undergoing institutional change, which is, in turn, a cognitive process. For this process, we can also assume that type C path-dependencies occur, resulting in a high complexity of the feedbacks between cognitive and institutional change, which can be described as a heterarchic evolutionary system.

From this overview, we can reach several straightforward methodological conclusions. I begin with the need to explore both institutions and cognitive models (in a similar vein, see Aoki, 2001). The latter is a challenge to economics, which mostly thinks of institutions as being context-free, because the rational actor is assumed as being a representative one. Understanding cognitive models requires a hermeneutic methodology that identifies meanings and possibly converts those into other systems of meanings that are shared in a scientific community.

As a second point, we need an explicit description of the paths of change. That is, the simple comparison between two states (such as 'planned economy' and 'market economy') is not sufficient in order to understand true path-dependencies of institutional change. Methodologically, this amounts to a reinstatement of historical methods in economics.

Third, both observations imply that there are certain limits to modelling, because the complexities of cultural meaning and of singular historical change require the use of 'normal language' to describe empirical facts. This is especially true for ambiguous states of institutional change, where competing cognitive models might support old and new institutions. Further, language is especially important for the 'translation' of cultural phenomena into the conceptual framework of the scientific observer.

Finally, we start out from certain assumptions about agency and causality in institutional change. For this, we adopt the common distinction between formal and informal institutions, with the former being those institutions that are enforced by organized power and are contained in written form. Formal institutions are the realm of institutional design. This reaches much further than government-backed institutions. However, in our context we will focus on this, since the starting point of Chinese transition is a state-controlled economy. Informal institutions are supported by social sanctions that are not governed by written rules. Thus, informal institutions are particularly prone to manifesting type A and B path-dependencies. Formal institutions can be changed by political fiat, informal institutions change as a result of social and cultural change, often unintentionally.

In sum, the methodology of cultural analysis in economics is a narrative approach, one that links up general causal hypotheses with particular contexts and singular sequences of events. The dominant economic methodology – that is, modelling techniques – continue to be important, however, they mostly play the role of a generator of interpretive schemes that do not have a direct empirical relevance. The main objective of cultural analysis is to deconstruct complex reality into networks of institutions and cognitive models, and to show how path-dependence constrains the direction of institutional change. Certain systematic phenomena might be arranged around a concept of culture. Let us shed some light on the Chinese case by applying this approach.

Property rights under socialism: deconstructing property as a cultural category in economics

One of the hallmarks of the Chinese transition is the slow process of introducing private property rights, which is strongly marked by the prevailing socialist ideology. From the viewpoint of the 'market and socialism' controversy, the co-existence of markets and some form of public ownership is certainly a most reliable indicator of a 'socialist' nature of the economic system.

To solve this apparent contradiction, following our methodological sketch, first, we need to distinguish clearly between formal and informal property rights in the sense of a set of segmented rights and claims of different groups (in a similar vein, see Hu, 1998). The interaction between formal and informal institutions is particularly strong in the Chinese countryside. We will have a closer look at property rights on land and on rural industry. Our aim is to understand the changes in the Chinese system of property rights as an outcome of the interaction between institutional design and culture.

Land ownership, social structure, and traditional views of livelihood

Apart from the distinction between formal and informal rights, we also need to make the underlying cognitive models explicit. This is especially important with regard to land ownership in peasant communities. Formally speaking, property rights over land in China are still clearly defined as belonging either to the state or to the collectives. This can be compared with the situation in traditional peasant communities, where land ownership is regularly embedded into a thick network of social obligations and is part and parcel of fundamental ideas of livelihood and distributional justice. Hence, we might guess that path-dependence could play an important role in institutional changes of the land property rights system.

As has been well documented by many observers, collectivization in 1949 never produced fully-fledged disappropriation of the Chinese farmers (for an exemplary study of rural society under Mao, see Potter and Potter, 1990). In many cases, the institutional outcome of collectivization was moulded after the social structure of villages, in that the set-up of production groups and brigades reflected both the kinship relations between farmers and the history of migration into the villages (Potter and Potter, 1990: 131, 251ff.). 'Collective property' was therefore cognitively blended with traditional perceptions of family and lineage property.

The traditional concept of property in China never supported the absolute property rights familiar in the Western world (for a classic survey, see Kroker, 1996 [1959]). Individual property was conceived as a relational category in two senses: first, property belongs to the family, in that the individual owner is only a temporary caretaker who is obliged to increase its value for the coming generations; and, second, individual property was perceived as being embedded in a web of social relations in the village, which was a major obstacle to the emergence of land markets in China. Instead, a complex system of tradable and embedded lease-rights emerged, especially in south-eastern China, in which the village and the individual farmer were maintained as fundamental social units, but the legal owners were sometimes several levels apart in a chain of sub-leasing contracts. Market development took place under the constraint of preserving the local peasant community, which is centred around the rituals of the field deities and lineages.[8] Very often, tenant farmers could claim factual property rights against landlords, who had to observe traditional norms of livelihood when taking decisions concerning the allocation of their land.

I posit that these traditional ideas have been an important force of path-dependence, and also in more recent economic changes in the Chinese countryside. Their revival after 1978 was strongly supported by the fact that collectivization had even strengthened the inward orientation of village communities (Shue, 1988). An illuminating observation is that, until recently, the majority of farmers did not prefer a system of fully-fledged private ownership of land.[9] The underlying motivation is a very old belief that households should obtain the basic endowment to maintain the family line. This belief implies, amongst other things, that in the Chinese system of inheritance there are basic rights of newly established families to obtain a livelihood through the division of family property (Cohen, 1992). The same principle applies in many Chinese villages in which the land use rights are redistributed much more frequently than stipulated by formal government regulations. The main reason is to adapt the distribution of land to demographic change. Thus, the collective property framework in the villages is actually a result of an interaction between formal and informal institutions and traditional notions of livelihood. There is a demand for security of claims to land that paradoxically works against privatization because only the collective rights can credibly secure rights to land for later generations, especially if those collective rights are implicitly related to kinship groups. However, in this sense the formally collective rights are, in fact, informal private rights of kinship groups, and the meaning of the formal institutions is embedded in cognitive models of traditional social relations.

However, collective ownership does not necessarily imply that there is a collective decision-making process over the allocation of land use rights. This is most evident from the recent controversies about the so-called 'enclosure' movement in the Chinese villages that are close to urban areas (21 shiji jingji daobao, 2004: 459ff.). This is a de facto privatization process that exploits the fuzziness of property rights resulting from the fact that the formal administration of collective land lies in the hands of local political elites; that is, the village cadres (Cai, 2003). The driving force is the reallocation of agricultural land to industrial uses, or even service uses, which provides very strong incentives for the private appropriation of land rents. According to Chinese regulations, farmers are remunerated after applying a measure of future returns from agricultural uses if they pass on their land use rights to other users. These formal regulations underestimate the actual value of land that materializes in other uses. Hence, the local administration can use subleasing contracts to appropriate the rent either for the government or even for private investors. In the latter case, these can be local entrepreneurs who strike a deal with local government, acquire the land use rights at a low price and extract the rents via the activities that they realize on the land. Via chain contracts, they could ultimately end up with the land use rights as almost perpetual leases. This 'privatization' is paradoxically completed if village land is turned into urban land: this means that it becomes formal state property, which can no be longer claimed by rural collectives. Thus, state ownership serves as a legal means by which to secure privately appropriated property rights. Frequently, this gives rise to distributional conflicts between village communities and recent settlers of the socialist period, because the claims on compensation are distributed according to the historical patterns of settlement. This reinforces traditional notions of community. The result is a path-dependent change of the entire institutional set-up and the related distribution of wealth.

We can summarize our historical account in terms of the structure depicted in Figure 7.1. Figure 7.2 shows the dynamics of institutional change during the Maoist era. We see that the competition of traditional norms and socialist notions of communities was a major countervailing force against formal collectivization. This was hidden behind the concepts that were actually applied to determine the borders of communities. From this, path-dependent changes of type A and B were triggered, which led to a diffusion of particular patterns of decentralization across China.

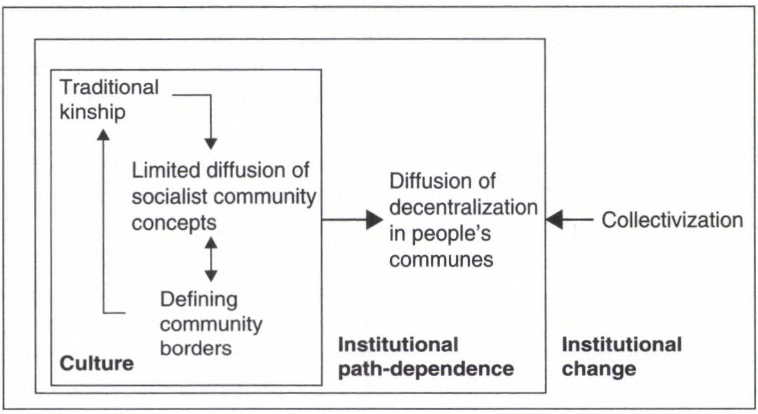


Figure 7.2 Path dependence of land property rights under Mao

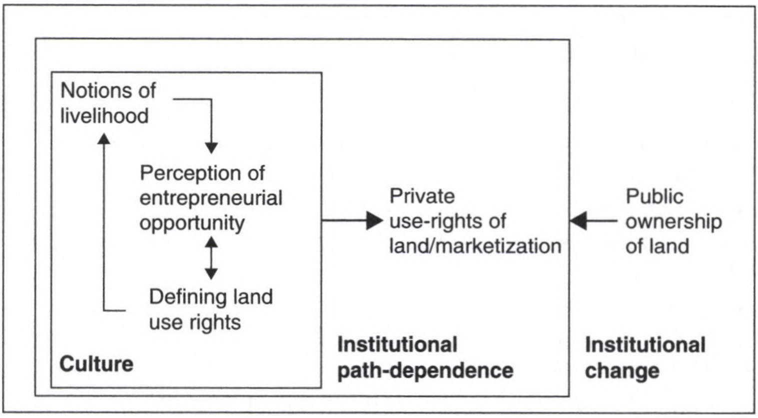


Figure 7.3 Path dependence of marketization of land use rights in contemporary China

In a similar vein, we can interpret the current marketization process (see Figure 7.3). Here, institutional design operates through the maintenance of the public ownership system. This formal institution is implicitly transformed into a system of private land use rights, a process being propelled by the demand for land through urbanization and marketization. The cultural forces are rooted in traditional notions of livelihood and subsistence, which play together with the perceptions of entrepreneurial opportunity generated by the reforms. On this, the actions operate to create procedures for defining and trading land use rights, which are reflective acts with reference to the prevailing cognitive schemes.

Thus, the case of property rights over land clearly shows that changing formal institutions are embedded into larger networks of informal institutions and cognitive models. These networks impose constraints on the potential effects of formal institutions. Both cases are possible. Formal institutions might be subverted, as in the case of collectivization, or they might emerge from a change of informal institutions, as in the case of de facto privatization. The 'socialist' nature of the land system in China is not simply an outcome of constitutional arrangements, but reflects a viable transient state in institutional change (Ho and Lin, 2003). Currently, social conflict emerging from the appropriation of collective land by special interests leads to a strengthening of claims to reconstitute farmers' land rights. Still, this does not necessarily point towards privatization (Chi Fulin, 2005: 20ff.). Path-dependent change is eventually mirrored in the 'ambiguity' of formal institutions (Ho, 2001). In the end, even in the context of rapid marketization of the rural society, land ownership retains its 'socialist' nature.

Property rights in rural industry: efficient governance in an uncertain environment

Path-dependent change of property rights is also a conspicuous phenomenon in the case of TVEs. Many observers emphasize the fact that, at the time of writing, Chinese TVEs are undergoing a more or less explicit privatization, with the concomitant change of policy categories from TVE to small and medium enterprise (SME) and a related change in the regulatory framework. However, this is not the full story. The situation regarding TVEs shows how social learning takes place with a strong interaction between institutional change and economic performance and efficiency. Again, the result is a state of institutional ambiguity that is only gradually resolved (for an early theoretical approach to this, see Li, 1996; in empirical terms, see Chen, 2004).

Because of limited space, I can only present some stylized facts, which do not reflect the high diversity of institutional forms in Chinese rural industries. The rise and decline of TVEs is a clear case of path-dependent gradualism, in which changing performance triggers institutional change, which is embedded in existing institutions and prevalent cognitive patterns. Furthermore, TVEs seem to be a clear case of path-dependent efficiency in the sense that they can be conceived as relatively optimal adaptations to a political environment that is marked by legal uncertainty. That is, they are a second-best solution in a fictitious environment of a perfect rule of law; however, since one cannot reasonably assume that the Chinese political system transforms itself by bootstrapping, efficiency can only be assessed endogenously.[10]

In a nutshell, TVEs emerged from the collective rural industries of the Maoist era and could develop speedily, particularly once they received support from local governments to obtain access to credit. This privileged position was lost in the first credit crunch in the early 1990s, when a major competitive advantage of collectively owned TVEs was gone. This resulted in strong pressure for restructuring. The most famous case is the so-called '*Sunan* model' that was silently and step-wisely dismantled after the crunch (*Caijing*, 2001).

However, this account does not fully reflect the nature of path-dependent change, which differs considerably across the Chinese regions, and even across villages, with idiosyncratic histories of change. One of the major factors is closely related to the case of land. Take, for example, the famous example of Wenzhou, where private enterprises flourish. Larger TVEs in Wenzhou frequently were simply lineage property; this occurs when villages are dominated by certain families (Wang and Zhu, 1996). In traditional China, complex businesses were already organized along lineage structures (Faure, 1996). Lineages could set up a governance structure that clearly separated management from ownership and assigned the position of a shareholder to the lineage members.

Kinship is not the only factor that interferes in the causal relationship between formal institutions and performance. Generally speaking, local government plays a crucial role in the success of TVEs because many business opportunities result from the intermediation of officials; for example, in setting up supplier networks with SOEs. Further, given the low reliability of the legal system in the countryside, political support is an important resource for businessmen. That means that, even if a TVE adopts a private governance structure, it is still positioned in a network of obligations and favours embedded in the local community. In other words, the formal differentiation between collective and private property rights masks a fundamental continuity of embedded rights and obligations in local networks that are the primordial foundation of business trust (Smyth, 1997).

The local community has claims on a TVE that can be expressed in different ways, and which, at least partly, are rooted in the collective ownership of land as one of the productive assets of industry (Pei, 2002). One claim is on employment opportunities, which segments the local labour market into insiders and outsiders. These claims can be further enforced in the shape of non-tradable shares that have actually been an enforced price of the workplace guarantee. Indeed, in the 1990s the complex networks of implicit rights were translated into a new transient form of governance, the so-called 'cooperative shareholding system'. This system had highly idiosyncratic features and was designed to formalize different claims that resulted from the migration history of villages, past investments and status differences between the general population and government. In a nutshell, it was designed to transform stakeholders into shareholders.

Once we look at the current situation, the interesting point is that even outright formal privatization processes do not change the embeddedness of property rights in the local community. This is evident from the way that management buy-outs (MBOs) are organized (Li and Rozelle, 2003). Very often, the negotiated price is very low, which is accompanied by the maintaining of residual claims to profit by the local government. This is a clear example of how even MBOs continue with mixed ownership because claims to residual income are a main component of property rights. Interestingly, there is both an efficiency explanation and a path-dependent explanation for this:

- In efficiency terms, one can argue that MBOs suffer from a serious problem in asymmetric information. The managers are much better informed about the future value of a firm than the formal owners; that is, the collective and the governments. Hence, they will systematically under-price the value of the assets. Local government is interested in maximizing revenue from an MBO, but has no reliable information about the value. A low asset price, while maintaining residual claims of both parties, is an incentive-compatible solution to this problem.
- Alternatively, this can also be explained with reference to networks of obligations. From this point of view, claims on residual income remain with both the entrepreneurs and the local community because both sides continue to invest in the creation of business opportunities. This is similar to the generalization of the Chinese business model as a 'network of enterprises' in which the entrepreneurial behaviour of the single enterprise is coordinated within a network that is based on certain social norms maintaining the traditional Chinese notion of *guanxi*. In rural China, this network includes the political actors, with shifting weights of importance of the different groups across the many realizations of the network principles.[11] In this perspective, property rights are embedded in social relations based on reciprocal utilization of social and political capital.

The example of TVE property rights is a clear case of path-dependence in all of the three senses that we analysed in the theoretical part of this chapter. The diffusion of private property rights in rural industry is a frequency-dependent process that was heavily influenced by cognitive schemes and communication. As is well known, Chinese transition has always been accompanied by an evolving process of the formal definition of institutions and boundaries of accessible institutional change. Politics imposed constraints on the perception of local developments across locations, because the public communication process was channelled within ideological limits of expression. This is particularly obvious in the slow and accelerating diffusion of the so-called 'Wenzhou' model of private enterprise in the Yangzi delta region (Feng, 2001). It could be put into the context of local cultural narratives, in that the exception remained in the scope of permissible variations in the spectrum of

Chinese socialism. At the same time, the diffusion of this model has faced many obstacles in Jiangsu province, because Jiangsu was hailed as following another model, the collective one. Even though the privatization of TVEs had already started in the late 1980s, this could not be reflected in official rhetoric, so the diffusion process was slowed down, as it had to proceed through additional institutional transitions, in particular the cooperative shareholding system.

Further, there were strong network effects, especially in terms of the embeddedness of formal institutions within informal institutions. Collective ownership showed a strong resemblance to traditional lineage structures and, in certain circumstances, it is merely private ownership without formal institutions. Traditional notions of inheritance and family management interact with the implementation of formal institutions. Beyond kinship, a more fundamental network effect results from 'networks' in the narrow meaning; that is, the peculiarly Chinese way of social interaction epitomized in the concept of *guanxi*. The embeddedness of economic action in webs of obligation and trust is a major constraint on the exertion of formal rights, in the sense that a formal act of privatization does not simultaneously cut the bonds of obligations in *guanxi*. And vice versa, formal constraints on action might be changed fundamentally via network action, resulting in a divergence between formal and informal property rights.[12]

We can summarize these observations in Figure 7.4, which applies the framework of Figure 7.1 again. On the one hand, there is no direct political intervention in the sense of institutional design but, instead,

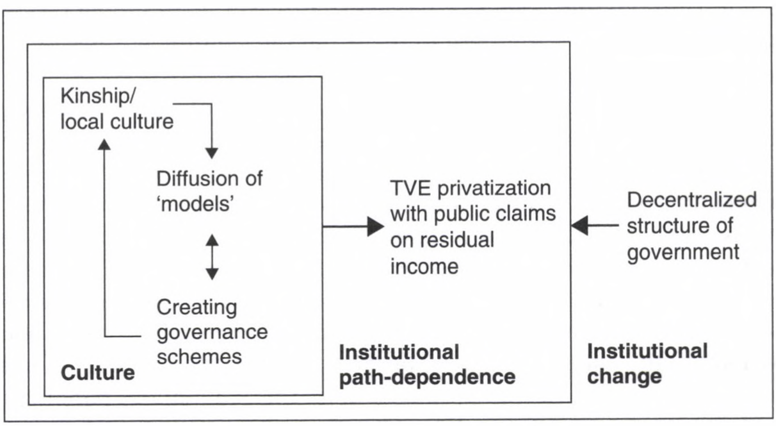


Figure 7.4 Path-dependent privatization of Chinese TVEs

a contextual impact of the Chinese state structure on institutional change. This refers particularly to legal uncertainty and the decentralized structure of government, with a relatively strong position for local government. Therefore, the main driving force of institutional change is culture, working under the constraints of market competition and its requirements for efficiency. Culture builds on traditional notions of kinship and community, which differ across China and therefore have a strong local background. This interacts with the diffusion of 'models' in the sense of policy frameworks during the Chinese transition, which eventually results in the emergence of governance schemes. These schemes cannot be exclusively reduced to formal institutions but are based on informal institutions, in particular social networks. The result is a path-dependent process of privatization that retains a peculiar interface between private business and public actors. Thus, property rights in rural industry defy a simple generalization. They are in constant flux, with strong path-dependence regarding the direction of change. Formally speaking, private property will be the outcome of the process, but this does not mean that the embedding factors at the economy/polity interface will lose force in Chinese rural society (drawing a similar conclusion, see Chen, 2004).

A missing piece

We have given a quick analytical glance at the role of property rights in the Chinese rural economy, from which a complex picture emerges. The 'socialist' nature of the institutions is related to a network of informal institutions and cognitive models that makes institutional change path-dependent. It is this pattern that I call the 'culture' of the Chinese economy in the real-typical sense.

Viewed from the outside, despite many reservations about the long-term viability of the current ambiguous system of property rights, the fundamental fact that counts is that the Chinese policies have been tremendously successful in terms of global institutional competition. Precisely the fact that institutional ambiguity leaves much room for interpretation shows that both the internal and external notions of efficiency need to be considered in terms of a global balance of the Chinese experience of gradualism. This can be grasped in more specific terms once we refer to the effects of the land property rights system on the political costs of transition, including, for example, the externalities potentially arising from the mass migration of landless peasants under full privatization. Collective land use rights allowed the mobilization of grassroots entrepreneurship via collaboration among local cadres and emerging businessmen. Rural industrialization served as a valve into which unemployment pressures could be released. Even though many enterprises could not survive for long, very often they supported structural change, building a scaffold on which more recent developments such as the rapid urbanization could proceed.

Still, an important part of the cultural puzzle of China is missing in our account. This is the interaction between the observer and the observed, both internally and externally. Since 1978, Chinese politics has been in search of a binding description of the Chinese system, moving from concepts of a 'planned commodity economy' to the 'socialist market economy', which in turn is characterized by different formulae, as the recent shift towards the emphasis on sustainable development and a 'harmonious society' have shown. Whether this also implies the return to some traditional notions of 'Chineseness' seems to be open, but this is clearly stated in the Chinese public debate by some influential thinkers.[13] For the outside observer, this question is implied by the general topic of this volume; namely, whether market and socialism are mutually compatible concepts. As I have tried to argue in this chapter, the answer to this question is highly contingent to our theoretical framework. As long as we operate with abstract notions of 'market' and 'socialism', this seems to result in an oxymoron. If we enlarge our framework with richer notions of path-dependent change, institutions and cognition, we can redefine our problem. The blend between market elements and socialist elements is now conceived as a reflection of cultural forces at work. These are not the simple generalizations over historical concepts such as religious systems, but much more complex interactions between institutions and cognitive models which are rooted in cognitive path-dependencies. In that sense, socialism becomes an element of culture, insofar as socialist institutions blend with informal institutions and socialist ideas merge with traditional notions of livelihood. From this, it follows that the future economic system of China will be the result of further cultural change and cannot be directly determined by political fiat.

Notes

1. This debate was gaining intensity in the late 1990s. An instructive exchange of controversial views took place between Rawski (1999) and Woo (1999).
2. This earlier approach was informed by North (1990) and built on the German tradition of 'Ordnungstheorie' (theory of order). North (2005) reinforces the argument.

3. In the history of economics, this is closely related to Max Weber's categories unfolding in 'Economy and Society'. There was a systematic attempt at developing 'intermediate theoretical concepts' which were sometimes called 'economic style', see Spiethoff (1971 [1932]).
4. The context-dependence of human decision behaviour has motivated Smith (2003) to introduce the term 'ecological rationality'. A much-quoted experimental study on this is Henrich *et al.* (2003).
5. O'Flaherty and Bhagwati (1997) have dubbed this problem the 'determinacy paradox'.
6. This effect has also recently been acknowledged by mainstream economists; see, for example, Alesina and Fuchs-Schündeln (2005) who demonstrate that even in Germany convergence among East and West German preferences for redistribution would presumably need two generations. I have discussed this theoretical issue in much detail already in Herrmann-Pillath (1992).
7. A fully-fledged economic theory of these interactions has been developed by Kuran (1995) who introduces the distinction between private, public and publicly revealed preferences. He assumes that people have preferences over degrees on conformity and process information about the opinions of others. Observation and communication cause frequency-dependent patterns of behaviour that actually conceal the 'true' private preferences.
8. Subsequently, I cannot pursue the important topic as to how in contemporary China local communities revive and maintain traditional ritual, in particular with reference to territory. For an illuminating survey, see Dean (2003). Tsai (2002) shows how the provision of public services in Chinese villages is influenced by the underlying social structure, in particular lineages and religious institutions.
9. See Kung and Liu (1997). Brandt *et al.* (2002) give a more detailed picture that questions the generalization over farmers' preferences because there is always a strong influence of village cadres on actual decision-making in the villages. Yet, they also show a strong correlation between demography and land reallocations, which reflects the subsistence norms of peasants. Zhang *et al.* (2004) argue that collective land ownership in Zhejiang has given rise to a peculiar institutional regime for markets in land use rights which, at the same time, lowers transaction costs and avoids the upsurge of the number of landless workers.
10. This is very clear from the analysis by Che and Qian (1998a, b). They argue that, given the lack of a rule of law protecting private business against state predation, TVEs are an efficient mid-way solution because local governments credibly protect their interests, therefore minimizing incentives to hide for revenue and ending up with a higher tax transfer to the central government and a better provision of public goods. The costs of this arrangement are continuing distortions of the incentives for the managers, which might be reflected in a relatively lower increase of incomes (see Jin and Qian, 1998).
11. For example, this can even include a situation where an enterprise almost completely absorbs the village structure (see Hu Biliang, 2004). The network approach to Chinese business has been particularly elaborated in Hamilton's work (see Hamilton, 1996) for his contributions and the related work of other authors.

12. For lack of space, I cannot go into detail here. Yang (2002) is a recent survey on the *guanxi* issue that emphasizes anthropological aspects, in particular with relation to issues of gender and power. It is important to understand the role of male networks in controlling different sources of capital in rural society, which transcends the more simple economic approach, which stresses lack of trust into formal institutions and therefore expects a retreat of *guanxi* during institutional modernization (see, for example, Guthrie, 1998). Gold *et al.* (2002) give access to the most recent research issues and results in the field at the time of writing.
13. For example, Gan Yang (21 shiji jingji daobao 2004: 3ff.) claims that we experience the transition from the national state to the 'civilizationary' state. In one of the leading journals, *Strategy and Management*, Kang (2003) characterizes the Chinese system by features such as 'immanentism' (*tian ren he yi*), 'moderation' (*zhong yong zhi dao*), or a special relation between 'elitism' (*jing ying zhu yi*) and 'populism' (*yi min wei ben*), which features cause a peculiarly Chinese pattern of institutional change to emerge.

References

21 shiji jingji daobao (2004) Zhongguo shiji. Xin de kaishe he jiyu (Hong Kong: Oxford University Press).

Ackermann, Rolf (2001) *Pfadabhängigkeit, Institutionen und Regelreform* (Tübingen: Mohr Siebeck).

Alesina, Alberto and Fuchs-Schündeln, Nicola (2005) 'Goodbye Lenin (or not?): The Effect of Communism on People's Preferences', http://post.economics.harvard.edu/faculty/alesina/papers/goodbyelenin.pdf

Aoki, Masahiko (2001) *Toward a Comparative Institutional Analysis* (Stanford: Stanford University Press).

Arthur, Brian (1994) *Increasing Returns and Path-dependence in the Economy* (Ann Arbor: University of Michigan Press).

Binger, Brian R. and Hoffman, Elizabeth (1989) 'Institutional Persistence and Change: The Question of Efficiency', *Journal of Institutional and Theoretical Economics*, 145(1): 67–84.

Blanchard, Olivier and Kremer, Michael (1997) 'Disorganization', *Quarterly Journal of Economics*, vol. 112(4): 1091–26.

Brandt, Loren; Huang, Jikun; Li, Guo and Rozelle, Scott (2002) 'Land Rights in China: Facts, Fictions, and Issues', *China Journal*, 47: 67–100.

Cai Yongshu (2003) 'Collective Ownership or Cadres' Ownership? The Non-agricultural Use of Farmland in China', *China Quarterly*, 175: 662–80.

Caijing (2001) 'Sunan yuyan', *Caijing Business and Finance Review*, May: 33–51.

Che, Jiahua and Qian, Yingyi (1998a) 'Insecure Property Rights and Government Ownership of Firms', *Quarterly Journal of Economics*, May, 113 (2): 467–96.

Che, Jiahua and Qian, Yingyi (1998b) 'Institutional Environment, Community Government, and Corporate Governance: Understanding China's Township-Village Enterprises', *Journal of Law, Economics, and Organization*, 14(1): 1–23.

Chen, Chih-jou Jay (2004) *Transforming Rural China: How Local Institutions Shape Property Rights in China* (Oxford and New York: RoutledgeCurzon).

Chi, Fulin (ed.) (2005) *Zhongguo Gaige Pinggu Baogao* (Beijing: Waiwen chubanshe).
Cimoli, Mario and Dosi, Giovanni (1995) 'Technological Paradigms, Patterns of Learning and Development: An Introductory Roadmap', *Journal of Evolutionary Economics*, 5: 243–68.
Cohen, Myron (1992) 'Family Management and Family Division in Contemporary Rural China', *China Quarterly*, 130: 357–77.
Dean, Kenneth (2003) 'Local Communal Religion in Contemporary South-east China', *China Quarterly*, 174: 338–58.
DiMaggio, Paul (1997) 'Culture and Cognition', *Annual Review of Sociology*, 23: 263–87.
Faure, David (1996) 'The Lineage as a Business Company: Patronage versus Law in the Development of Chinese Business', in Brown, Rajeswary A. (ed.), *Chinese Business Enterprise*, vol. 1 (London and New York: Routledge): 82–106.
Feng, Xingyuan (2001) Shichang hua: difang moshi de yanjin daolu, Zhongguo nongcun guancha, 1: 2–11.
Gold, Thomas; Guthrie, Doug and Wank, David (eds) (2002) *Social Connections in China. Institutions, Culture, and the Changing Nature of Guanxi* (Cambridge: Cambridge University Press).
Guthrie, Doug (1998) 'The Declining Significance of Guanxi in China's Economic Transition', *China Quarterly*, 154: 254–82.
Hamilton, Gary (1996) *Asian Business Networks* (Berlin and New York: de Gruyter).
Henrich, Joseph; Boyd, Robert; Bowles, Samuel; Camerer, Colin F.; Fehr, Ernst; Gintis, Herbert and McElraeth, Richard (2003) 'In Search of Homo Oeconomicus: Experiments in 15 Small-Scale Societies', *American Economic Review*, 91(2): 73–9.
Herrmann-Pillath, Carsten (1992) 'Informal Constraints, Culture and Incremental Transition from Plan to Market', in Wagener, H.-J. (ed.), *On the Theory and Policy of Systemic Change* (Heidelberg: Physica): 95–120.
Herrmann-Pillath, Carsten (1994) 'China's Transition to the Market: A Paradox of Transformation and Its Institutionalist Solution', in Wagener, H.-J. (ed.), *The Political Economy of Transformation* (New York: Physica-Verlag and Heidelberg: Springer-Verlag): 209–41.
Ho, Peter (2001) 'Who Owns China's Land? Property Rights and Deliberate Institutional Ambiguity', *China Quarterly*, 166: 394–423.
Ho, Samuel P.S. and Lin, George C.S. (2003) 'Emerging Land Markets in Rural and Urban China: Policies and Practices', *China Quarterly*, 175: 681–707.
Hu, Biliang (2004) 'Yi chang dai cun' yu nongcun fazhan', *Zhongguo nongcon diaocha*, 58: 2–16.
Hu, Xiaobo (1998) 'Informal Property Rights and Their Formalization in 1997: A Political Economy Analysis', *China Review 1998* (Hong Kong: Chinese University Press): 313–38.
Ingold, Tim (1993) 'The Art of Translation in a Continuous World', in Pálsson, Gísli, (ed.), *Beyond Boundaries. Understanding, Translation and Anthropological Discourse* (Oxford and Providence: Berg).
Jin, Hehui and Qian, Yingyi (1998) 'Public vs. Private Ownership of Firms: Evidence From Rural China', *Quarterly Journal of Economics*, August, 113(3): 773–808.
Kang, Shaoguang (2003) 'Zhongguo Teshu Lun – Dui Zhongguo Dali 25 Nian Gaige Jingyan De Fansi', *Zhanlüe Yu Guanli*, 4: 56–62.

Kennedy, Scott (2003) 'The Price of Competition: Pricing Policies and the Struggle to Define China's Economic System', *China Journal*, 49: 1–30.
Kroker, Edward (1996 [1959]) 'The Concept of Property in Chinese Customary Law', in Rajeswary Ampalavanar Brown (ed.), *Chinese Business Enterprise, Vol. IV* (London: Routledge).
Kung, James K. and Liu, S. (1997) 'Farmers' Preferences Regarding Ownership and Land Tenure in Post-Mao China: Unexpected Evidence from Eight Counties', *China Journal*, 38: 33–64.
Kuran, Timur (1995) *Private Truths, Public Lies. The Social Consequences of Preference Falsification* (Cambridge and London: Harvard University Press).
Li, David (1996) 'A Theory of Ambiguous Property Rights in Transition Economies: The Case of the Chinese Non-State Sector', *Journal of Comparative Economics*, 23: 1–19.
Li, Hongbin and Rozelle, Scott (2003) 'Privatizing Rural China: Insider Privatization, Innovative Contracts and the Performance of Township Enterprises', *China Quarterly*, 176: 981–1005.
Mantzavinos, Chrysostomos (2001) *Individuals, Institutions, and Markets* (Cambridge: Cambridge University Press).
North, Douglass C. (1990) *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press).
North, Douglass C. (2005) *Understanding the Process of Economic Change* (Princeton and Oxford: Princeton University Press).
O'Flaherty, Brendan and Bhagwati, Jagdish (1997) 'Will Free Trade With Political Science Put Normative Economists Out of Work?', in *Economics and Politics*, 9(3), 207–19.
Pei, Xiaolin (2002) 'The Contribution of Collective Landownership to China's Economic Transition and Rural Industrialization', *Modern China*, 28(3): 279–314.
Potter, Sulamith Heins and Potter, Jack M. (1990) *China's Peasants. The Anthropology of A Revolution* (Cambridge: Cambridge University Press).
Rawski, Thomas G. (1999) 'Reforming China's Economy: What Have We Learned?', *China Journal*, 41: 139–56.
Schachtschabel, Hans G. (ed.) (1971) *Wirtschaftsstufen und Wirtschaftsordnungen* (Darmstadt: Wissenschaftliche Buchgesellschaft).
Schlicht, Ekkehart (1998) *On Custom in the Economy* (Oxford: Clarendon).
Shue, Vivienne (1988) *The Reach of the State. Sketches of the Chinese Body Politic* (Stanford: Stanford University Press).
Smith, Vernon L. (2003) 'Constructivist and Ecological Rationality in Economics', *American Economic Review*, 93(3): 465–508.
Smyth, Russell (1997) 'The Township and Village Enterprise Sector as a Specific Example of Regionalism – Some General Lessons for Socialist Transformation', *Economic Systems*, 21(3): 235–65.
Spiethoff, Arthur (1971 [1932] 'Die allgemeine Volkswirtschaftslehre als geschichtliche Theorie. Die Wirtschaftsstile', *Schachtschabel*: 123–55.
Strauss, Claudia and Quinn, Naomi (1997) *A Cognitive Theory of Cultural Meaning* (Cambridge: Cambridge University Press).
Tsai, Lily Lee (2002) 'Cadres, Temple and Lineage Institutions, and Governance in Rural China', *China Journal*, 48: 1–28.
Wang, Xiaoyi and Zhu, Chengbao (1996) *Zhongguo Xiangcun De Minying Qiye Yu jiazu Jingji. Zhejiang Sheng Cangnan Xian Xiangdong Cun Diaocha*, in *Dangdai*

Zhongguo De Cunzhuang Yu Cunluo Wenhua Congshu, Vol. 5, Chen, Jiyuan and Carsten Herrmann-Pillath, Carsten (eds) (Taiyuan: Shanxi jingji chubanshe).
Witt, Ulrich (1989) 'The Evolution of Economic Institutions as a Propagation Process', *Public Choice* 62: 155–72.
Woo, Wing Thyy (1999) 'The Real Reasons for China's Growth', *China Journal*, 41: 115–38.
Yang, Mayfair Mei-hui (2002) 'The Resilience of Guanxi and Its New Deployments: A Critique of Some New Guanxi Scholarship', *China Quarterly*, 170: 459–76.
Zhang, Qian Forrest; Ma, Qingguo and Xu, Xu (2004) 'Development of Land Rental Markets in Rural Zhejiang: Growth of Off-farm Jobs and Institution Building', *China Quarterly*, 180: 1050–72.

8

Market Economy, Hierarchy and Single-Party Rule

Barry Naughton

The survival of an authoritarian administrative hierarchy is the most surprising feature of Chinese economic reforms, as well as the most under-analysed. Today, in China, and Vietnam as well, almost all economic transactions are carried out through the market, but the political hierarchy continues to claim ultimate economic authority. This is surprising because, although the presence of an administrative hierarchy was an integral feature of the old 'command' economy, it seems to have lost most of its economic functions today. Indeed, the hierarchy today is most commonly seen as a vestige of the past, whose anomalous survival is due solely to the Communist Party's political interests.

However, a closer look reveals that this 'vestigial' interpretation is not tenable. In order to survive, the authoritarian hierarchy had to be adapted to dramatic changes in the overall political and economic environment. Moreover, those observed changes in the authoritarian hierarchy had a significant impact on the trajectory of economic transition. The basic argument of this chapter is that, in order to carry out the dual-track transition strategy adopted in the 1980s, it was necessary to strengthen incentives and authority relations within the hierarchy. This approach was successful in enabling a relatively smooth and rapid transition to a market economy, and it left China with an ongoing legacy: a revitalized and strengthened administrative hierarchy. While this hierarchy has some advantages, overall it is not well adapted to today's market economy. This interpretation provides insight into four broad questions.

- Why did the authoritarian hierarchy not collapse in China as it did in the Soviet Union?
- How was it that, against expectations, the political hierarchy was reshaped and strengthened during the process of market transition?

- In what ways did the authoritarian hierarchy shape the market transition process?
- What is the significance for the contemporary economy, as a revitalized but still authoritarian political hierarchy struggles to govern a dynamic market economy?

In this chapter, I first put the Chinese political hierarchy in the context of multi-task principal-agent theory. That allows me to characterize the political hierarchy pre-reform, and then address the question of commitment to the hierarchy. The natural expectation at the beginning of economic reform was that the introduction of markets would produce new incentives that would cause members of the hierarchy to shift their effort towards market goods. As members gradually shifted from political goods to market goods, their commitment to the hierarchy would decline, and the hierarchy itself would decline in importance (Nee and Lian Peny, 1994). In the first section, I show that this gradual changeover from hierarchy to market cannot generally occur. Instead, if the hierarchy is to avoid a precipitous collapse, incentives within the hierarchy must be strengthened to reinforce commitment, and keep the system in equilibrium.

The second section moves to the description of the Chinese experience, showing that Chinese policy-makers greatly strengthened incentives within the hierarchy. During the first era of economic transition (1978–93), four separate but mutually reinforcing policies contributed to incentives becoming more 'high-powered' (having steeper reward functions). How did it happen in China that so much attention was focused on rebuilding, strengthening and 'incentivizing' the administrative hierarchy? In part, this is explained by the improvised adaptation of the hierarchy to the introduction of markets. An important additional explanation, however, is that economic reform coincided with the perceived need to rebuild the administrative and Communist Party hierarchies after the Cultural Revolution. Indeed, this was part of the personal political project of Deng Xiaoping.

The third section considers the impact of strengthened incentives within the hierarchy on the economic transition process itself. During the first phase of economic reform (1978–93), market reform was built upon the ability of reformers to structure a 'dual track' economic system. Since this dual track system presupposed the persistence of some kind of economic plan, it was self-evidently predicated on the survival of a hierarchy. But, in fact, the interactions between hierarchy and dual-track transition strategy are even closer than that. It turns out there is a surprising and paradoxical complementarity between strengthened incentives in the hierarchy and marketization of the economy. This complementarity helps explain the success achieved by the Chinese economy during the 1980s.

The fourth section describes the obsolescence of the complementary institutions that were so important for the early stages of transition. This built-in obsolescence is an example of a general managerial dilemma. If the Chinese government had been able, credibly, to commit to maintaining the existing plan targets, then they would gradually have become irrelevant as the economy 'grew out of the plan'. However, the government would also have steadily surrendered its claim on potential enterprise revenues. If the government revised the targets, though, the incentive properties of the dual track system would be lost. Unable to resolve this dilemma, the government switched economic strategies, and abandoned the dual track strategy.

The final section considers how this change in transition strategy was made. By differentiating the treatment of different sectors, tasks were bundled into more specialized and more clearly partitioned jobs. Under these conditions, the hierarchy no longer had an intimate interconnection with market transition. Nevertheless, the hierarchy with high-powered incentives survived, and it has continued to be restructured and continuously remade. This restructured hierarchy does not appear to be well-adapted to the contemporary Chinese economy, and the next stages of adaptation are difficult to predict.

China as a multi-task principal-agent hierarchy

In developing economies, it is common for governments to take a large role in the economy, which means that hierarchical solutions take the place of market solutions. Arguably, this is a reasonable response to the pervasiveness of market failure and market underdevelopment in underdeveloped economies. Missing markets, information asymmetries, market power and complex externalities undermine the efficiency of the market economy. Under these circumstances, hierarchy arguably has fewer costs and higher benefits than would be the case in developed economies.

The socialist command economies were, however, extreme in their reliance on hierarchical solutions because the administrative hierarchy was intended to be all-encompassing. The planned economy theoretically covered all of society and the economy: nothing was excluded.

Inevitably, then, under the old system, officials were given broad portfolios and extensive authority. If the top leaders decided something was of interest, they decreed that it should interest government and party officials at all levels. Hough (1969) characterized local party officials in the then-Soviet Union as 'prefects' because of their broad responsibilities and extensive discretionary powers. This characterization describes China before economic reform even more forcefully. During the Cultural Revolution, various hierarchies became even less functionally specialized. Slogans of the day declared that 'the Party should lead everything', that decision-making should be 'united under the Party's single rule', and most famously that 'politics should be in command'. Under these conditions, individual managers were responsible for an extraordinarily broad range of activities and outcomes. Agents had multiple tasks.

Communist Party-run systems are also unusual because all the principal-agent relationships are knitted into a single hierarchical system. The Communist Party controls the *nomenklatura*; that is, the system of job assignments throughout the economy. Each job is given a specific rank, extending from the top political leader all the way down to an ordinary official in a rural township. The *nomenklatura* process unites the political, administrative and economic hierarchies into a single system. State-owned enterprises (SOEs) are fully incorporated into this system, and every SOE has an administrative rank that determines the bureaucratic rank of the enterprise manager's job (Harasymiw, 1969; Voslensky, 1984; Manion, 1985; Burns, 1989, 1994; Heilmann and Kirchberger, 2000). Combining the all-encompassing and unitary nature of the hierarchy, a Communist Party-run command economy can be accurately characterized as a multi-level hierarchy of multi-task principal-agent relations.

The modern theory of principal-agent relations has developed many important propositions, some of which can be directly applied to the Chinese experience. Principal-agent theory analyses the way that the agent can be motivated to act in the social interest, examining the trade-off between risk and reward, in the presence of imperfect information. Multi-task principal-agent models, such as that of Holmstrom and Milgrom (1991) expand on this analysis. In the multi-task model, the agent must allocate time, attention, and effort between multiple tasks. The basic insight is that the different tasks are substitutes in the agent's cost of effort function. More time and effort devoted to one task makes the time available for the other task more scarce, and the effort more costly. Thus, reward functions, in addition to motivating the agent, also direct the allocation of the agent's effort between his various duties. The design of reward functions by the principal must take into consideration the effect on one activity of the reward set for another activity.

> ***Proposition 1***: Before economic reform, incentives within the administrative hierarchy pre-reform were generally 'low-powered'. Incentives in China were even lower powered than in other socialist command economies.

'Low-powered' incentives means that agents received little or no monetary reward directly linked to task completion. If we describe an individual's income with the equation $Y = \beta + \alpha\ (m)$, where β is a fixed wage and m is a success indicator, then a small or zero value of α indicates a shallow slope of the compensation schedule, which equals 'low-powered' incentives.

Socialist systems are often considered, in a non-reflexive way, to have had 'inadequate incentives', caused by the dominance of socialist ideology and the absence of a system for rewarding risk-takers and entrepreneurs. It is important to recognize that this is *not* the analysis being undertaken here. On the contrary, it is quite possible for a socialist system to provide high-powered incentives (steep compensation functions), when a narrow sphere of authority has been identified. This was the case, for example, in the former Soviet Union, where monetary payments were made for fulfilling specific success indicators, but only in economic units. Large annual bonuses, or premia, were given to factory managers, and workers were often on piece rates. However, these compensation functions did not extend to other sectors in the Soviet and East European planned economies. Moreover, they were almost non-existent in China. What explains this difference?

In situations where agents within the hierarchy had responsibility for many different tasks, incentives were generally low-powered. This was as true for government officials within the Soviet hierarchy ('prefects') as it was for Chinese officials generally. Because of the political line that commanded Chinese officials to be 'red and expert' and not make a fetish out of production, agents in China routinely had to balance many competing tasks and demands on their time. They were almost never rewarded for achieving a specific task but, rather, for doing well everything they were told to do. Specific performance indicators were rarely mentioned and almost never explicitly rewarded. Chinese policy under Mao abolished cash payments for specific tasks. There were always incentives at work, however, because career incentives were always present. Individuals moved up through the hierarchy into jobs of increasingly higher rank, which involved higher pay, and abundant perks and discretionary power. Agents were employees, not contractors. They could increase their incomes only by performing according to the principal's instructions on an ongoing basis and gradually receiving promotion.

These observed outcomes are well explained by standard incentive theory, to which we now turn in order to proceed with the argument. In the principal-agent framework, each agent is assumed to have a strictly convex cost of effort function, $C(e)$. The agent's effort produces a signal, $m(e)$, that provides information (with stochastic error) to the principal about outcomes that the principal values. The principal, in turn, sets a compensation function (which we assume to be linear) that rewards the agent based on the observed level of the signal, or success indicator. Thus, the individual's reward function is $R(e) = \alpha[m(e) + \varepsilon]$, and the agent is assumed to maximize $R(e) - C(e)$, so that $R'(e) = C'(e)$. The principal-agent framework is powerful in part because it explicitly incorporates the agents' risk aversion and the extent to which the agent's effort can be accurately observed. However, the basic insight of the multi-task principal-agent model can be applied to China by using the illustrative simplifying case of certainty and perfectly observable success indicators.[1] In the multitask case, the agent will be seen to allocate effort among different tasks such that for all separate tasks:

$$R_i(e) = C_i(e) \tag{1}$$

where subscripts denote partial derivatives. That is, the agent will allocate his effort among different tasks such that the marginal cost of effort and the marginal return to effort are equal across all tasks.

However, there are interactions among the tasks in the agent's cost of effort function. When tasks are complements ($C_{ij} < 0$), engaging in task j lowers the cost of incremental effort in task i. When tasks are substitutes ($C_{ij} > 0$), engaging in task j raises the cost of incremental effort in task i. The simplest form of substitutes occurs when agents have a limited total amount of time or attention available for different tasks, and there is therefore a trade-off among those tasks in the cost of effort function. From the principal's standpoint, the optimal compensation rule also depends on these interactions. So long as $C_{ij} \neq 0$, the principal should set the compensation for success indicator i at a level that takes these interactions into account. If tasks are substitutes, making the compensation steeper for task i (raising $R_i(e_i)$) has an additional cost because it makes the effort invested in task j more costly.

Consider the limiting case in which an agent has a fixed amount of time or effort, $\bar{e}$, to allocate to two different tasks. To anticipate the following discussion, assume that there is effort devoted to economic development (e_1) and to diverse political tasks (e_2). The principal has to decide how much to reward agents for economic development effort, while the agent's problem is:

$$\text{Max } R^1(e_1) + R^2(\bar{e} - e_1) - C(\bar{e}) \qquad (2)$$

The agent's solution to is to set $R^1_1 = -R^2_1$. Now switch to the perspective of the principal. The principal has an overall benefit function, in which both economic development and political tasks play a role. If the two were independent in the agent's cost of effort function, the principal would simply reward the agent up to the point where the marginal payment to the agent equalled the marginal value of economic development effort in the principal's benefit function. However, given the interdependence of the two types of effort, the principal is aware that effort on economic development comes at the expense of effort on political tasks. All else held equal, this causes the principal to lower the marginal reward for effort on economic development. The trade-off is particularly acute if the principal does not have a good success indicator to measure effort on political tasks. If there are no available performance indicators that can measure the output of political tasks, it will not be feasible to reward the agent for those tasks. In that case, R^2_2 will be at or close to zero (and R^2_1 as well). It will be optimal for the principal to reduce R^1_1 so that the agent does not entirely neglect political tasks.

This explains the observation that incentives were low-powered in China before economic reform. The principal – in this case, the top political leadership of the Cultural Revolution era – was eager to encourage a portfolio of political tasks that they could not directly monitor. Only over time could they judge whether an agent was sufficiently 'red' and sufficiently capable to merit promotion. Rewarding economic development effort would have drawn effort away from this unobservable portfolio. But, with low-powered incentives, agents would simply do whatever they were told. The overall level of effort might be below the optimum, but compliance with instructions would be reliable. Even relatively weak career incentives might be adequate to motivate an acceptable level of overall effort, since political careers were the only game in town. No outside private activities that would compete for the agent's attention were permitted, and low and uniform consumption standards made it easy to monitor agents' compliance with instructions from the principals. The system was in an internally consistent low-powered incentive equilibrium.

> ***Proposition 2***: The legitimation of 'external' private activity disrupted the incentive system that prevailed in the pre-reform hierarchy.

I define as 'external' any activity that an individual undertakes on his own without instructions from the hierarchy. It includes starting an independent business, assisting others going into business, or diverting public resources – including one's own on-the-job time and effort – into an enterprise that benefits oneself. Needless to say, the personal benefit can be enjoyed indirectly through benefiting friends and family, or by receiving informal payments in gratitude for assistance provided in the past. The appearance of a new 'external', private activity draws effort away from the existing activities. Agents will reduce their input of effort into those existing activities, and this could threaten the survival of the hierarchy.

We examine this issue further by returning to the agent's maximization problem, which is now:

$$\text{Max } R^1(e_1) + R^2(\bar{e} - e_1 - e_p) + P(e_p) - C(\bar{e}) \tag{3}$$

where $P(.)$ indicates a private, or external, activity that contributes to the agent's family welfare directly. The system was previously in a low-power incentive equilibrium, but the introduction of new activity disrupts that equilibrium. Agents respond to the opportunity of a new activity by reallocating effort to that activity. In the face of this adjustment process, the principal has three options.

The first option is to do nothing. In this case, agents will continue to shift effort to the external activity as long as the return to that activity is higher than the return to 'internal' activity (that is, R^1 and R^2, activities that are assigned and rewarded within the hierarchy). Agents will reduce the effort devoted to activities rewarded by the hierarchy, and thereby reduce their commitment to the goals espoused by the hierarchy. Principals will experience declining outputs of goods they value, a decline in the effectiveness of the hierarchy and, perhaps, a reduction in their overall benefits.

The second option is to restrict returns to the external activity. The principal can limit private external returns by prohibiting agents from running businesses by themselves, and by promulgating laws prohibiting corruption and rewarding transparency. Ultimately, though, it is only possible to reduce private external returns to a very low level by aborting the marketization process.

The third option is to increase the rewards given to internal activities. By offering the agent a steeper reward function, the pay-off for effort devoted to internal activities is increased. If a new equilibrium is established, the return to effort will be equated across both internal and external activities:

$$R_1^{1\prime} = P' = -R_1^{2\prime} = -R_p^{2\prime} \tag{4}$$

This outcome will be acceptable to the principal if the overall benefit of allowing external activities is greater than the aggregate cost of rewarding agents for their individual efforts for internal activities. Note that, for this equilibrium to be established, the principal must find a way to reward the second activity, which (by assumption in the previous description) could not be readily measured by any available success indicators.

If the principal does nothing, the hierarchy is in danger of dissolving. Since the market economy has almost unlimited potential to develop, the private activity P is unlikely to run into diminishing returns quickly. Moreover, if 'spontaneous' or *nomenklatura* privatization is seen as possible, agents might devote virtually all their effort to strategizing to benefit from privatization. The experience of the Soviet Union accords with this scenario. During the 1980s, Gorbachev weakened the command hierarchy, intentionally and unintentionally (Suraska, 1998). The combination of attractive external activities with weakened hierarchical oversight caused agents to dramatically re-allocate effort to private activities. Solnick (1996) dramatically described what happened next, in a process he likened to a bank run. Each individual agent perceived that other agents were re-allocating effort away from the tasks assigned by the hierarchy and, as a result, they reduced their commitment to that hierarchy. The system quickly reached a 'tipping point'. Individuals began to 'abandon ship', behaviour changed; there was a scramble for assets; and the system collapsed with remarkable speed. No one seemed to have anticipated such a remarkable outcome.

The analysis presented here shows that there is not a simple linear process in which the return to market goods increases and gradually surpasses the return to political goods. Instead, the incentives for effort within the hierarchy must be competitive with incentives for private, external activities. If not, the progressive reallocation of agent effort to private goods will create a 'cascade' of defection from the regime. Our analysis suggests that it is precisely in this area that Chinese experience first diverged fundamentally from Soviet experience. Chinese policy-makers were anxious to ensure that incentives within the hierarchy remained strong. They dramatically increased the pay-off to effort devoted to tasks inside the hierarchy. Chinese policy-makers adopted a broad portfolio of policies that each had the effect of increasing incentives within the hierarchy. We describe those policies in greater detail in the following section. These policies had the effect of preventing defections and reinforcing commitment to the regime. When combined with policies that limited potential returns to external activity by forbidding privatization and capping the size of new private businesses – elements of the second option – these actions prevented the erosion of the hierarchic system.

Strengthening incentives within the Chinese hierarchy

From an early stage of the transition process, Chinese policy-makers began introducing high-powered incentives for their agents within the hierarchy to produce those outcomes that were desired by the leadership. Success indicators became increasingly explicit, and compensation functions became much steeper. I refer to these steeper compensation functions as 'high-powered' incentives, and (interchangeably) refer to the adoption of high-powered incentives, as 'incentivization'.

> ***Proposition 3***: During the 1980s, Chinese policy-makers introduced high-powered incentives throughout the hierarchy.

Many different strategies were deployed to strengthen incentives within the hierarchy. Four strategies were most important: cash payments, regularized career paths, conditional access to market opportunities, and particularistic contracts. These were introduced in virtually every corner of the administrative hierarchy. In this section, I discuss these in turn, beginning with the incentive mechanisms that are simultaneously the most mechanical and the most 'internal' to the hierarchy: cash bonuses for task completion and career incentives. I then expand the discussion to include conditional access to market opportunities and particularistic contracts.

Cash payments for task fulfilment were re-introduced at the beginning of China's market transition. Bonuses were quickly introduced for workers and managers in the production sectors and, to a limited extent, piece rates as well. These early actions merely revived typical Soviet-style rewards that had been abolished during the Maoist era, but this kind of straightforward 'incentivization' quickly went beyond anything familiar in the Soviet Union. Monetary bonuses spread to nearly every type of government employee, including physicians and teachers. Most important, government officials began to receive significant cash bonuses associated with fulfilment of targets and success indicators. By 1982, a national 'cadre responsibility system' provided for systematic evaluation of government officials at all levels through a system of success indicators (*kaohe zhibiao*) and their reward with year-end bonuses. Since then, cadres have been annually assigned points in several different policy arenas. The total score – typically out of 100 possible points – is the basis for the cadre's annual bonus: a cadre's annual income can easily be doubled by a large bonus (Edin, 2000: 125–40; Whiting, 2001, 2004).

This system was an obvious adaptation to the new pressures on the hierarchical system during the reform era. The 'Four Modernizations' reflected the high priority policy-makers now placed on economic growth, following which they naturally sought to focus cadre effort on economic development tasks. At the same time, as national policy lost its ideological content and the state retreated from its effort to control ordinary peoples' lives, it became less important to motivate effort on the diverse portfolio of hard-to-monitor political activities. The incentive to engage in economic development activities could be raised, without too much concern about the reduced effort going to political activities. Economic development targets became the most important component of overall cadre evaluation, and success in meeting those targets was directly rewarded. For general government officials, indicators related to economic development – GDP growth, tax collections and industrial output – typically accounted for 60–65 points out of the 100 total possible. There were also non-economic indicators in the annual evaluation. These were indicators that were relatively easy to monitor precisely, which reflected cadre effort in issue areas about which the national leadership remained concerned. Most important were family planning targets – where the number of births could be directly measured, albeit with error – and social order, where the number of incidents of popular protest were counted (and given a negative value). This pattern is as would be expected under multi-task principal-agent theory predictions on a functioning hierarchy. As incentives for one task (economic development) become more high-powered, the principal also strengthens the incentives to engage in other tasks – if, and only if, those other tasks can be closely linked to a success indicator that can be monitored with reasonable accuracy. Under this principle, a few less crucial, but still important, targets can sometimes be slipped into the evaluation framework. In southern China, for example, cadres sometimes get a few points based on the percentage of dead bodies cremated. The link to an important policy purpose is that bodies not cremated are buried in graves – sometimes elaborate graves – that intrude on scarce farmland. However, only by linking compensation to an indicator that can be accurately monitored (as overall land use cannot) can the broader policy purpose be encouraged. Thus, as the reward for economic development is raised, the whole network of incentives mechanisms is pulled taut, and high-powered rewards applied to many eligible areas. The balancing of incentives inside the hierarchy mirrors the balancing of incentives within and outside the hierarchy that is our main topic.

The second way the existing hierarchy was 'incentivized' was through career paths that were gradually institutionalized. An effort to rebuild and regularize the personnel system dated from the very first days of the reform era. The rebuilding of the government hierarchy immediately after the Cultural Revolution created many new government jobs and, at first, many of these jobs were filled by older officials who had been sidelined by the Cultural Revolution. However, the focus quickly shifted to the identification and promotion of capable, relatively educated younger cadres. Younger officials provided skills and energy the country desperately needed, and their promotion made it clear that an orderly promotion path existed. Deng Xiaoping himself took the lead in re-establishing a regular system of promotion and career predictability. Deng also took the lead in trying to establish a norm of retirement, urging elder leaders to step down. Although this achievement was limited by the ambivalence of the veteran leaders, including Deng himself, by 1988 an automatic retirement age had been created for all but the top elders themselves (Manion, 1992: 20–4). These measures made career-based incentives more predictable and more powerful. Moreover, for local officials, promotion was directly dependent on economic performance (Li and Zhou, 2005). A milestone in the process came in 1982–84, when many educated younger officials were promoted and a select group was fast-tracked for future leadership roles. This fast-track group included Hu Jintao and many of the other officials who stepped into the top leadership positions 20 years later, in 2002. Reasonably predictable career incentives within the hierarchy were thus achieved (Bo, 2004; Li, 2004).

The first two strategies under discussion are both normal incentive mechanisms within a hierarchical context, albeit their rapid and broad application was somewhat unusual within the context of a socialist government hierarchy. The final two strategies, however, describe incentive mechanisms that are more unusual, and which have a stronger connection to the market transition process. We defer the discussion of market transition to the next section, however, and focus here on their incentive properties within the hierarchy itself.

The third strategy policy-makers used to strengthen incentives within the hierarchy was to make access to market opportunities conditional upon continued affiliation with the hierarchy. This was particularly true during the first decade of reform, up until 1993. In the first place, privatization was kept off the agenda. With privatization taboo, there were limits to how lucrative the private external activity could be. The possibility of ending up in control of assets worth millions or even billions of dollars was virtually zero. Moreover, during this first decade, the opening of the economy was almost never subject to universal rules. Starting and growing a business was a widespread opportunity, but not a right, so business people always had to maintain close relations with the hierarchy (Pei, 2006: 31–3). The most important sources of entry in the 1980s were township and village enterprises. These local firms always had to maintain an accommodation with local Party and government officials, since they were tied to their locality in a society still characterized by limited mobility. Some maintained an identity as 'collectively owned', even when they were the products of individual entrepreneurship. Local officials benefited from the attention, and the hierarchy was reinforced as a requirement for personal advancement and enrichment. In other respects as well, new economic opportunities were made available to Party stalwarts first. Special economic zones and Hong Kong-based Chinese companies were staffed by officials sent from Beijing, often the children of high party officials. All these things strengthened the influence of the hierarchy. For those inside the hierarchy, abandoning the hierarchy altogether was not an attractive option. Entrepreneurs and others outside the hierarchy had to continue to curry favour with officials in the hierarchy. This de facto policy of 'conditional access' permitted space for market development even as it must have slowed down market development.

This analysis helps to explain why predatory behaviour by government officials did not choke off market reforms altogether. Corruption and predatory behaviour are serious problems in China, as agents push up the return to $P(e)$ by squeezing resources from the private sector. However, it is often remarked that corruption in China does not seem to be serious enough to choke off economic growth, and many analysts have described this as a paradox. But since access to lucrative private activities depends on affiliation with the hierarchy, potential predators expect that the income sources they covet will be attached to the hierarchy for an extended period. Thus, the local government, as a unit of the hierarchy, has a certain customary property right in the local income generating activity (Che and Qian, 1998), and this discourages local officials from excessive predation. Moreover, the ongoing process of strengthening the hierarchy gives superiors tools for monitoring compliance and corruption by agents. The government is acutely aware of the danger of reduced commitment to the hierarchy, and corruption is one of the most corrosive forces reducing that commitment. Thus, the hierarchy gives the government oversight, and the commitment to maintenance of the hierarchy gives the government the motivation to use those oversight tools. Finally, the appeal of predatory behaviour is reduced by market competition. Since no individual jurisdiction has the ability to control trade, the ability to profit from market distorting behaviour is limited (Montinola, Qian and Weingast 1996). These factors constrained the ability of agents to choke off market development. As for the principals, although they were not completely unwavering in their support of market development, they only sporadically and inconsistently restricted market development. In the end, their desire to foster economic development kept the process moving ahead.

The final strategy that was used to strengthen incentives within the hierarchy was that deployment of particularistic contracts through virtually every sector of the economy. Superiors wrote contracts that specified an adequate level of performance – usually based on the previous year's outcome – and then provided high-powered incentives for the subordinate unit. This was the basis of the well-known 'dual-track' strategy. There was a fixed plan target, negotiated by superiors and subordinates on the basis of past performance, and then generous rights to retain product and revenues for anything above that plan target. In such a circumstance, contracts were essentially specifying a fixed payment from each subordinate unit. This system of contracting then spread to virtually all economic units affiliated with the hierarchy. By the late 1980s, explicit fixed payment contracts had been signed by virtually all of China's farm households, over 80 per cent of state-owned enterprises, all provinces, all provincial foreign trade bureaux and most sub-provincial governments. Contracts with high marginal retention rates were ubiquitous in the Chinese economy.

It is worth emphasizing how unusual China's pervasive use of high-powered incentive contracts really was. Most large bureaucratic organizations use high-powered incentives sparingly, or not at all. Holmstrom and Milgrom (1991) note that large organizations use incentive contracts far less often than standard principal-agent theory predicts, and introduce their multi-task version in part to explain the puzzle of pervasive *low-powered* incentives. China's highly incentivized bureaucracy is really outside the norm of large organizations, to say nothing of government bureaucracies.

Particularistic contracts reinforced power relationships inside the hierarchy, even as they strengthened economic incentives. Work units had to fulfil targets set by superiors before they could gain access to the generous marginal retention rates available 'above plan'. Enterprise managers curried favour with their superiors and tried to show that they were good corporate citizens, in the hope of obtaining a 'slack' plan target. Those superiors converted their ability to grant a slack target into a patronage resource. Managers had more leeway, more resources, and better incentives, but they were still dependent upon a superior in the hierarchy setting the baseline for their incentive contracts. What Kornai (1987) labelled the 'dual dependence' of the enterprise – dependent both on the market and on the bureaucracy – was perpetuated under the Chinese strategy. The same dynamic was at work wherever particularistic contracts and high-powered incentives were introduced, including central–local fiscal relations and foreign trade companies.

The outcome of all these forces was a national set of policies that strengthened *both* incentives to engage in market activity and incentives to comply with performance indicators established by the hierarchy. Each of the four policies described in this section had the effect of strengthening commitment, and the result was a resilient restructured hierarchy. To see the ultimate impact of these policies, it could be useful to turn to a qualitatively different type of evidence. Recent work on the determinants of urban incomes provides useful insight. During the reform period, the structure of labour markets has changed dramatically. For example, returns to education were once extremely low, but have increased dramatically to levels comparable with other middle-income developing countries. During this period, what has happened to the economic return to affiliation with the hierarchy? We can ask this question by examining the return to Communist Party membership in a model of urban income determination. According to the best study available, the coefficient on Communist Party membership in an urban Mincerian wage regression, *increased* steadily from 6.8 per cent in 1988 to 18.1 per cent in 1999. After 1999, the premium levelled off, and might have declined slightly through 2003 (Appleton, Song and Xia, 2005; see also Zhou, 2000). While such numbers cannot be conclusive, they are consistent with an interpretation that says the Chinese regime was able to increase the return to regime affiliation, and thereby avert a crisis of commitment that would undermine the regime.

The administrative hierarchy was a necessary condition to implement China's 'dual track' transition strategy

Given that the administrative hierarchy survived and was, in crucial respects, strengthened during the 1980s, what was its impact on China's economic transition? The administrative hierarchy was an essential precondition of China's 'dual track' transition strategy, in both obvious and surprising ways. The dual-track system has been well-described in the economics literature (Byrd, 1991; Qian, 2003; Naughton, 2007), and is not further analysed here. We can ask, however, to what extent the advantages of the dual-track system were dependent upon the survival of the administrative hierarchy as an organization capable of delivering effective commands that were in general obeyed. There were three crucial respects in which the transition based on the dual-track system relied on this hierarchy.

First, and most obviously, the dual track is 'dual' precisely because goods are allocated by both market and plan. The allocation of goods by an authoritative plan obviously requires a hierarchy to aggregate and disaggregate allocation decisions. The dual-track system thus requires a 'plan' and therefore requires a hierarchy as well (Blanchard and Shleifer, 2001). But all transition economies began their transition with a plan and a hierarchy in place: it is simply that China took the steps to keep this hierarchy in place for over a decade while the market economy grew around it. The ability to determine production and revenue 'base figures' was essential to allow market prices to be quickly established 'at the margin', with minimal disruption to the economy as a whole.

Second, this same ability to assign each production unit a 'base figure' was the key to creating a 'reform without losers' (Lau, Qian and Roland, 2001) during the first period of reform. 'Base figures' in essence 'grandfathered in' every production unit at their achieved level of performance. It was the assignment of the base figure that allowed the system to move all enterprises onto a market track immediately, without regard to the huge differences in production efficiency that prevailed in the economy. In turn, this ability to grandfather in all existing enterprises is also an essential prerequisite for the political economy case for gradualist transition laid out in Roland (2000). In Roland's view, gradualist transition is superior because it allows a low-cost search for successful reform policies, in which the costs of reform are deferred, while the benefits of reform are gradually identified and revealed to beneficiaries. This helps overcome the general political economy problem of reform, which is that concentrated and organized interest groups that would lose from reform overwhelm the diffuse and unorganized (because unaware) potential beneficiaries of reform.

However, the interdependence between hierarchy and dual-track transition goes well beyond the above two factors. In fact, strengthening the hierarchy and implementing dual-track market reforms are incentive-compatible. Indeed, there is an implicit complementarity between the hierarchy and dual-track reforms. The transition to a market economy requires that much more powerful incentives be available to entrepreneurs and managers. Incentives must be powerful enough to change entrenched behaviours and motivate the acquisition of new skills. But an apparently simple 'unleashing' of market forces has the danger of degenerating into a simple scramble for control over hitherto public assets. By contrast, the Chinese effort to shore up the administrative hierarchy meant the incentives became more high-powered simultaneously inside and outside of the hierarchy. The economy as a whole became incentivized, without creating massive opportunities for windfall gains for those bold enough to seize control of public assets. The Chinese response to the opportunity of the market economy served to draw effort into the hierarchy, as well as into the market, and paradoxically this strengthened the overall transition process.

The focus of reformers on the institutional environment of the administrative hierarchy meant that the regulatory institutions of the emerging market economy were comparatively neglected. Yet, surprisingly, under these circumstances the economy was still able to grow and exploit new sources of supply and productivity improvement. Political and economic debate was ongoing about what rules would be appropriate to govern the new market sphere. The reform process gradually revealed important compromise solutions relating to these rules; for example, as land was contracted to households in the countryside. Still, what is perhaps most impressive, in retrospect, is precisely how little rule change was required in the most critical areas of the economy. The foundations of public ownership were unchanged. Bureaucratic lines of subordination remained fundamentally unchanged. Agents were permitted to benefit from successful investment of their local resources, but benefits could only be indirect and position-dependent. Clearly, during the first decade of Chinese reform, rebuilding the hierarchy, regularizing it, and above all, 'incentivizing' it, was sufficient to support a dramatic economic transformation, even without the full range of market-supporting institutions.

An obsolescing bargain

The system of incentives described in the previous two sections is not stable in the long term. On purely incentive-theoretic grounds, the system is subject to a fundamentally unresolvable dilemma. In the face of this dilemma, policy-makers in fact abandoned the dual-track system at the beginning of the 1990s, and moved to a different transition path. The fundamental dilemma for the managerial principals at the top of the hierarchy is that between maintaining the existing 'base figures' (equivalently, the fixed delivery obligations) and experiencing a steadily eroding share of total output, versus revising delivery obligations and losing the desirable incentive characteristics of the system. If the existing base figures were maintained, government revenue would essentially be fixed in absolute terms. Since the overall economy was growing robustly, government revenues as a share of the economy would erode, and government ability to provide essential public goods would be undermined. On the other hand, if the government were to increase the delivery obligations – that is, revise the plan targets upward – this would fatally undermine the incentive properties of the whole system.

These problems are intrinsic to the incentive package that China adopted to get through the first stage of market transition. The set of complementary institutions China adopted during the 1980s were effective in eliciting effort so long as they were credible. By giving lower level units control over their surplus above a certain base figure, Chinese leaders had muddled through to a system that gave their agents the incentives to reveal hidden information and invest effort up to the efficient point. But, as in all such systems, this mechanism was not profit maximizing for the principal – the central government – and therefore could not be credible in the long term (Miller, 1992). The central government itself had every incentive to increase its own share of the surplus, even though this meant choosing a less efficient incentive system. After all, if the Chinese government had really been willing to transfer the control of economic surplus above a certain base figure to its agents permanently, it would have been equivalent to privatization, which was not seriously countenanced by the most important policy-makers through the early 1990s.

The internal Chinese discussion that went on in the early 1990s about changing reform strategy was not framed in the language of incentive theory. Rather, it was discussed in terms of a crisis of state capacity. With budget revenues declining as a share of GDP annually since 1978, by the early 1990s, it seemed plausible that the central government's share of the total surplus had declined to such an extent that it would be unable to provide the most essential public goods. Meanwhile, changes in the macroeconomic environment made the intrinsic dilemma of the incentive system increasingly overt. Entry and competition by start-up firms was eroding the cushion of monopoly profits that sheltered state firms and hid cases of egregious inefficiency. Maintaining the incentive system was in conflict with the goals of increasing the budgetary share of the economy. Moreover, it was increasingly in conflict with the politically comforting policy of 'no losers'. The costs of propping up highly inefficient firms under the 'no losers' policy became increasingly overt. If the state's commitment to fixed delivery targets was indeed credible, these zombie firms would have to be put back onto their own resources, and many would go bankrupt.

Under these circumstances, the dual-track system and all its concomitants were abandoned at the end of 1993. The state plan was abolished, and with it all the 'base figures' and particularistic contracts that were associated with it. Within a year, a new tax system was rolled out for state companies. A fundamental turning point in transition strategy was reached. That turning point in economic policy (Qian and Wu, 2003; Naughton, 2007) involved a shift from decentralization and particularistic contracting, towards recentralization combined with a greater arms-length, regulatory approach to economic units competing in the marketplace. Policy-makers began to aspire to a level playing field. This shift in policy compelled a further adaptation of the hierarchical relations described in the previous sections. A new round of adaptation was touched off that detached many elements of economic decision-making from the core administrative hierarchy. However, this process left that administrative hierarchy intact and, in some respects, stronger and more effective.

Adaptations to the hierarchy in the contemporary period (1993–2007)

In the early 1990s, there was a period in which it appeared that administrative hierarchy was in turmoil. The survival of the hierarchy was, at first, obscured by the profound crisis around Tiananmen in June 1989. The authoritarian political system appeared to be in turmoil at the top, and its survival uncertain. But, gradually, it became clear that the hierarchy had survived, and perhaps even been strengthened by the purge of its heterodox elements. Since 1993, we have observed a process of adaptation that has left us with the extraordinary picture of an authoritarian hierarchy in the midst of a vibrant market economy.

After the abolition, at the end of 1993, of the system of incentive mechanisms that covered virtually all of Chinese society in the 1980s, economic transition launched on a strategy of differentiation. Incentive mechanisms were restructured in different ways in different sectors of the economy. Whereas one of the key characteristics of the incentive environment in the late 1980s had been its *unity*, one of the key characteristics after 1993 was the diversity of approaches followed as incentive policy began to differentiate systematically among different sectors. Thus, our account of the adaptive hierarchy loses the narrative unity it possessed for previous periods. However, we can briefly survey a few of the most important policies that were part of the functional differentiation and specialization process. At the end of the section, we return to the core government/Party administrative hierarchy.

Job design can serve as a general heading under which to consider the nature of the changes from an incentive-theoretic standpoint. When agents face difficult trade-offs among multiple tasks, a fundamental way to manage the hierarchy is to group tasks together in a way that facilitates the use of incentive instruments. Improving 'job design' means to reduce the number and diversity of tasks over which the average agent has responsibility. As Chinese policy-makers searched for ways to restructure specific sectors – or allow those sectors to begin to evolve out of their control – they groped for solutions that would package tasks into efficient job assignments. Those job assignments would ideally group together activities that were complements in the agents' cost of effort functions, as well as tasks that would have similar responsiveness to incentive payments. In pursuit of these objectives, a much broader range of incentive instruments became available in the course of the 1990s. Most important was the fact that privatization became politically acceptable, and so devolution of asset ownership to agents became feasible. Other factors that expanded the universe of incentive mechanisms were the growth of market supply and the gradual development of administrative and regulatory capabilities. With this expanding menu and an increasingly diverse set of economic circumstances, a broad range of incentive outcomes developed. Here, we briefly survey three areas to give a flavour of the change. What replaced the hierarchical, high-powered contracting approach to incentives in each of the three most important economic sectors?

Township and Village Enterprises (*TVEs*): The change of incentive mechanisms for TVEs was the most straightforward, and the best analysed of the lot. Contracting mechanisms were extended in duration, and then gradually shifted into locally-run privatization programmes. After 1993, virtually all TVEs were detached from the local government hierarchy, and then gradually privatized. The transfer of asset ownership was the key means of restructuring after 1993, and private ownership became the most important incentive mechanism (Li and Rozelle, 2003).

Central government enterprises: At the top of the government hierarchy, there has been no privatization of large central government enterprises. Instead, the 'ownership' of central government enterprises has increasingly been transferred to a specialized government 'ownership agency'. In the government administration, there has been a strong trend towards the separation of functions, as most government agencies have moved in the direction of becoming regulatory agencies (Yang, 2004). The ownership agency, the State-Owned Assets Supervision and Administration Commission (SASAC), was not formally established until 2003. However, the basis for its management was created in 1997 when the policy of 'focusing on large firms, and letting small firms go' was ratified at the 15th Party Congress. That policy committed the centre to a sort of non-compete and non-intervene position vis-à-vis local government firms. SASAC itself is designed to be a powerful and authoritative body that will exercise ownership rights, with authority over assets, personnel and business strategy, but only over a specified list of central government enterprises. These enterprises are still part of the administrative hierarchy, but the principals (China's top leaders) have committed themselves, in theory, to delegating authority to an appointed board of directors for each firm. The board of directors can be expected to give greater priority to profit maximization, reducing the importance of other tasks in the manager's basket of success indicators (Naughton, 2007: 314–23).

Local government enterprises: The most diverse set of changes have occurred in the local enterprise sector. After the central government renounced its ownership claim on local firms, local governments gained increased authority to manage their own economies, including permission to begin substantial privatization. Local governments actively exploited the freedom given to them by the implementation of the Company Law in 1995. The Company Law provided a general legal framework that permitted sales of stakes in state-owned companies, diversification of ownership stakes, and distribution of ownership stakes to managers. Thus, its promulgation began a gradual, incremental process by which local agents were given overall authority and quasi-ownership rights over public assets in their local economy. This franchising of the state sector unleashed a flood of creative arrangements at local level, including new alliances between government officials and private businesses.

Thus, we can see that after 1993, when the government abrogated its existing incentive bargain with subordinates, and recentralized significant control over taxation and regulatory authority, it simultaneously followed through with further rescinding of control over assets. This decontrol was differentiated into three major segments: township and village enterprises (which were privatized); local government-run enterprises (which were delegated to the sole authority of local officials, who often elected to privatize them); and central government-run enterprises (which were re-structured under SASAC, the central government ownership agency). In all three cases, managers were arguably given greater autonomy and greater long-term authority over valuable assets. However, equally important from our perspective is that in all three cases, managers were unambiguously made responsible for a narrower range of more focused tasks. SOE heads became more like company managers, and less like mayors of small towns. Rural entrepreneurs were freed to focus on increasing profits. And, in small cities, entrepreneurs and local government officials were given greater leeway to negotiate business strategies that were mutually beneficial. In all these cases, the hierarchy became much less all-encompassing, tasks were grouped together in ways that were more compact and made agents easier to monitor and motivate.

Despite these important changes, the central Party/government hierarchy remained what it had become in the 1980s, an administrative hierarchy with unusually high-powered incentives. Cash incentives, based on the cadre responsibility system, are still in place throughout the administrative hierarchy. Career incentives continue to be strengthened by regulations that clarify the system and promote regular job turnover. A list of educational and age requirements are enforced for each job. Most striking has been the near-universal application of age limits, that require 'up or out' for senior officials around age 55, depending on the administrative level (Bo, 2004; Regulations, 2003). This focus on career regularity, combined with the fact that the Communist Party is the organization that directly manages careers, has given the Communist Party a new channel to exercise authority in the contemporary period.

China's administrative hierarchy today is anomalous in its continuing use of high-powered incentives within the bureaucracy. Particularistic contracts have now been generally abandoned, and most economic sectors have been opened up to private business. However, cash bonuses and carefully regulated promotion paths are still used to reinforce compliance. Moreover, access to private business opportunities is still subtly conditioned on acquiescence to the hierarchy, even if this fact is not as overt as in the past. Yet, these incentive mechanisms do not have the integral relation with market transition strategy that they had in the 1980s. Indeed, an ongoing puzzle is whether the incentives in the administrative hierarchy serve a clear economic purpose, or whether they simply serve to reproduce the existing political hierarchy.

On occasion, the personnel power in the hands of the Communist Party is used to achieve specific restructuring goals. The best-documented example of this is the restructuring of the financial sector that took place in 1998 (Heilmann, 2005). An extraordinary Communist Party body, the Financial Work Small Group, was created to oversee the appointment of personnel in the reorganized banking system. This 'small group' insured the success of the administrative recentralization of the banking system by staffing each of the new regional banking districts directly, in a highly centralized fashion. In this way, it was made clear that the new regional bank heads did not owe allegiance to the provincial authorities (as in the past), but to the centre. The process thus reasserted the latent central control of the personnel system through the Party. The banking system that emerged from this process, more directly subject to central government direction and regulation, was clearly an improvement from the standpoint of the economy.

Nevertheless, this type of extraordinary use of authoritarian intervention is relatively rare, and somewhat anomalous within the general market context. There could be economic benefits from the ability to intervene authoritatively in the economy on occasion, overriding entrenched interest groups, and representing the public interest. However, such an argument is inevitably double-edged. Decisiveness comes at the cost of predictability and the credibility of long-range commitments. Moreover, the Communist Party is itself an interest group, and one that possesses excessive discretionary power.

Indeed, there is a serious question as to whether the set of incentive mechanisms applied in the core administrative hierarchy are appropriate to China's contemporary economy. To be sure, government and Party officials continue to have a broad portfolio of responsibilities, and still qualify as multi-task agents. But with government officials no longer having as much direct responsibility for economic management, it is no longer clear that high-powered incentives to promote economic development are appropriate. Are incentives within the administrative hierarchy too powerful?

There is a growing recognition that the basket of success indicators that apply to local government officials – these have not changed much in the past decade – might no longer be relevant to the real challenges China faces. Local success indicators still give the strongest weight to economic development. Yet, in the real economy, the challenge for the past several years has not been fostering growth but, rather, regulating and containing it. After all, China's economy grew at over 10 per cent annually from 2002 to 2007, investment rates were sustained at unprecedented highs above 40 per cent of GDP, and the central government tried repeatedly to cool the economy with a mix of macroeconomic and administrative interventions. Under these circumstances, did it make sense to be giving local officials cash bonuses and promotions for rapid GDP growth in their localities? Moreover, as development occurred, the indicators of the population's improved wellbeing have become more diverse and less easy to measure with a single success indicator. Under these circumstances, the basic problem of multi-task principal-agent systems might be reasserting itself: providing high-powered rewards for one task has a hidden cost in drawing effort away from other tasks that are substitutes in the agents' cost of effort function. For example, increasing environmental problems have recently been linked with this over-emphasis on a narrow definition of economic growth, and the large rewards given to local officials who preside over rapid GDP growth. For the first time, China's 11th Five Year Plan (released in 2005) explicitly called for a de-emphasis of traditionally narrow economic incentives for local officials and the broadening to a basket of 'sustainable' indicators (Naughton, 2005). This can be seen as the first stirrings of an effort to adapt the incentive system to a new set of challenges.

Conclusion

In this chapter, I have described the Chinese transition process through the lens of a constantly adapting multi-level, multi-task principal-agent hierarchy. I have shown that a few simple elements of incentive theory can explain a surprisingly large portion of the Chinese transition experience. Chinese leaders, conceived of as the principals, introduced a set of high-powered incentives into their multi-task hierarchy in order to maintain the commitment of agents and ensure the perpetuation of the hierarchy over which they presided. Fortuitously, the effort to incentivize the hierarchy turned out to be complementary with the introduction of markets through the dual-track system. Chinese policy-makers adapted the hierarchy to spread the dual-track system throughout the economy, and used that strategy to grow the economy successfully out of the plan. But Chinese leaders were nothing if not adaptable, and when the economy-wide system of high-powered contractual incentives exhausted its usefulness, it was abandoned.

The most important legacy of that period today is the survival of a core administrative hierarchy that operates on the basis of unusually high-powered incentives. In a sense, the high-powered incentives within that hierarchy serve the function they were intended to serve when introduced, that of reinforcing commitment to the current regime. However, it is not clear that these incentives any longer serve economic functions outside the hierarchy. Indeed, the theory of multi-task principal-agent relations suggests these high-powered incentives will focus effort on easily measured indices such as GDP growth, and draw effort away from the increasingly complex and multi-dimensional challenges that China faces as it moves to middle-income status.

Note

1. Risk aversion on the part of agents is a crucial part of principal-agent analysis, but is not necessary to drive any of the results discussed here. The assumption that success indicators are perfectly observable is not really a special case, since, as Holmstrom and Milgrom (1991) note, the agent's effort choice can always be formulated in such a way that effort is exerted in order to achieve an expected observed value of the success indicator.

References

Appleton, Simon; Song, Lina and Xia, Qingjie (2005) 'Has China Crossed the River? The Evolution of Wage Structure in Urban China during Reform and Retrenchment', *Journal of Comparative Economics*, 33: 644–63.

Blanchard, Olivier and Shleifer, Andrei (2001) 'Federalism With and Without Political Centralization: China Versus Russ', IMF Staff Papers, 48, Special issue: 171–9.

Bo, Zhiyue (2004) 'The Institutionalization of Elite Management in China', in Naughton, Barry and Yang, Dali (eds), *Holding China Together: Diversity and National Integration in the Post-Deng Era* (New York: Cambridge University Press): 70–100.

Burns, John P. (1989) *The Chinese Communist Party's* Nomenklatura *System: A Documentary Study of Party Control of Leadership Selection, 1979–1984* (Armonk, NY: M.E. Sharpe).

Burns, John P. (1994) 'Strengthening Central CCP Control of Leadership Selection: The 1990 *Nomenklatura*', *China Quarterly*, 138: 458–91.

Byrd, William (1991) *The Market Mechanism and Economic Reforms in China* (New York: M.E. Sharpe).

Che, J. and Qian, Yingyi (1998) 'Insecure Property Rights and Government Ownership of Firms', *Quarterly Journal of Economics*, 113(2): 467–96.

Edin, Maria (2000) *Market Forces and Communist Power: Local Political Institutions and Economic Development in China* (Uppsala: Uppsala University Printers).

Harasymiw, Bohdan (1969) '*Nomenklatura*: The Soviet Communist Party's Leadership Recruitment System', *Canadian Journal of Political Science*, 2(4): 494–7.

Heilmann, Sebastian (2005) 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry', *China Quarterly*, 181: 1–21.

Heilmann, Sebastian and Sarah Kirchberger (2000) *The Chinese* Nomenklatura *in Transition: A Study Based on Internal Cadre Statistics of the Central Organization Department of the Chinese Communist Party*, Trier University (Germany), Center for East Asian and Pacific Studies, China Analysis 1.

Holmstrom, Bengt and Milgrom, Paul (1991) 'Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design', *Journal of Law, Economics and Organization*, 7, Special issue: 24–52.

Hough, Jerry (1969) *The Soviet Prefects; The Local Party Organs in Industrial Decision-Making* (Cambridge, MA: Harvard University Press).

Kornai, János (1987) 'The Dual Dependence of the State-owned Firm in Hungary', in Tidrick, Gene and Chen, Jiyuan (eds), *China's Industrial Reform* (New York: Oxford University Press): 317–38.

Lau, Lawrence J.; Qian Yingyi and Roland, Gerard (2001) 'Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition', *Journal of Political Economy*, 108 (1): 120–43.

Li, Cheng (2004) 'Political Localism versus Institutional Restraints: Elite Recruitment in the Jiang Era', in Naughton, Barry and Yang, Dali (eds), *Holding China Together: Diversity and National Integration in the Post-Deng Era* (New York: Cambridge University Press): 29–69.

Li, Hongbin and Li-an, Zhou (2005) 'Political Turnover and Economic Performance: The Incentive Role of Personnel Control in China', *Journal of Public Economics*, 89: 1743–62.

Li, Hongbin and Rozelle, Scott (2003) 'Privatizing Rural China: Insider Privatization, Innovative Contracts and the Performance of Township Enterprises', *China Quarterly*, 176(1): 981–1005.

Manion, Melanie (1985) 'The Cadre Management System, Post-Mao: The Appointment, Promotion, Transfer and Removal of Party and State Leaders', *China Quarterly*, 102: 203–33.

Manion, Melanie (1992) 'Politics and Policy in Post-Mao Cadre Retirement', *China Quarterly*, 129: 1–25.

Miller, Gary (1992) *Managerial Dilemmas: The Political Economy of Hierarchy* (New York: Cambridge University Press).

Montinola, Gabriela; Qian Yingyi and Weingast, Barry (1996) 'Federalism, Chinese Style: The Political Basis for Economic Success', *World Politics*, 48(1): 50–81.

Naughton, Barry (2001) 'Changing Horses in Midstream? The Challenge of Explaining Changing Political Economy Regimes in China', in Wu, Jaushieh Joseph (ed.), *China Rising: Implications of Economic and Military Growth in the PRC* (Taipei: Institute of International Relations, National Chengchi University): 37–65.

Naughton, Barry (2005) 'The New Common Economic Program: China's Eleventh Five Year Plan and What It Means', *China Leadership Monitor*, 16.

Naughton, Barry (2007) *The Chinese Economy: Transitions and Growth* (Cambridge, MA: MIT Press).

Nee, Victor and Peng, Lian (1994) 'Sleeping with the Enemy: A Dynamic Model of Declining Political Commitment in State Socialism', *Theory and Society*, 23 (April).

Pei, Minxin (2006) *China's Trapped Transition: The Limits of Developmental Autocracy* (Cambridge, MA: Harvard University Press).

Qian, Yingyi (2003) 'How Reform Worked in China', in Rodrik, Dani (ed.), *In Search of Prosperity: Analytic Narratives of Economic Growth* (Princeton, NJ: Princeton University Press): 297–333.

Qian, Yingyi and Wu, Jinglian (2003) 'When Will China Complete Its Transition to the Market?', in Hope, Nicholas; Yang, Dennis and Li, Mu Yang (eds), *How Far Across the River? Chinese Policy Reform at the Millennium* (Stanford: Stanford University Press).

Regulations (2003) *Dangzheng Ganbu Xuanba Renyong Guiding* [*Regulations on Selecting and Appointing Party and Government Cadres*] (Beijing: Zhongguo Fazhi).

Roland, Gérard (2000) *Transition and Economics: Politics, Markets, and Firms* (Cambridge, MA: MIT Press).

Solnick, Steven (1996) 'The Breakdown of Hierarchies in the Soviet Union and China: A Neoinstitutional Perspective', *World Politics*, 48(2): 209–38.

Suraska, Wisla (1998) *How the Soviet Union Disappeared: An Essay on the Causes of Dissolution* (Durham, NC: Duke University Press).

Voslensky, Michael (1984) *Nomenklatura: the Soviet Ruling Class* (Garden City, NY: Doubleday).

Whiting, Susan H. (2004) 'The Cadre Evaluation System at the Grass Roots: The Paradox of Party Rule', in Naughton, Barry and Yang, Dali (eds), *Holding China Together: Diversity and National Integration in the Post-Deng Era* (New York: Cambridge University Press): 101–19.

Yang, Dali (2004) *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China* (Stanford: Stanford University Press).

Zhou, Xueguang (2000) 'Economic Transformation and Income Inequality in Urban China: Evidence from Panel Data', *American Journal of Sociology*, 105, 4: 1135–74.

9

Market Economy with Socialistic Orientation: The Evolution in Vietnam

Le Dang Doanh

Introduction

This chapter describes the long and painful journey undertaken by Vietnam's Communist Party in the search for an appropriate model for the type of society the Party sought to achieve. It deals with the Party's exploration of the balance between different powers and various doctrines in order to find its own route to the creation of a prosperous, free, democratic society living in national harmony, equality and human dignity, and called 'socialism'.

The first section describes the historic development of Vietnam until the implementation of Soviet-style socialism. In 1924, Nguyen Ai Quoc, who later adopted the name Ho Chi Minh, expressed the idea on which Marx had founded the Marxist principles based on the history of Europe. Asian nations could add their specific contribution to this doctrine. In 1925, he intended to 'implement the principles of New Economic Policies in Vietnam's economy'. He considered national liberalization as a strong driving force for colonial countries. His attempt to implement this idea faced criticism and rejection from the Komintern.

In 1930, Ho Chi Minh established the Communist Party of Vietnam instead of the Communist Party of Indochina, as had been directed by the Komintern. After 1945, he succeeded in building a coalition government, including former high-ranking mandarins, nationalists, intellectuals, and so on, rather than replicating the dictatorship of the proletariat and class struggle.

During the revolutionary action that took place between 1930–45 and the resistance against the French invasion between 1946–54, the concept of socialism – a society in prosperity, equality and fraternity – was proclaimed to be a dream as there was no understanding of how to establish it in practice. From 1945 until 1953, Ho Chi Minh implemented his own concept.

The second section describes the real impact of the model of Soviet-style socialism in Vietnam. Under the strong influence of the Soviet Union and the CPC, since 1953 Vietnam has implemented the concept of socialism without it being supported by sufficient theoretical foundation and material preconditions. Regardless of the personal disagreement of Ho Chi Minh, the first attempt to introduce socialist reconstruction in North Vietnam was implemented between 1955–9, leading to disastrous 'land reform' followed by collectivization of farmers into agricultural cooperatives from 1953 until 1956 in the rural regions. In the urban regions, the confiscation and quasi nationalization of the private capitalistic sector in industry and trade led to the decline of domestic industrial output. All these measures caused serious and deep wounds in Vietnamese society. Not only were the expropriators expropriated; moreover, the national traditions and culture were severely damaged. The industrialization that followed during 1960–5 was inefficient. The war in North Vietnam during 1964–75 was linked with enormous hardship, restraints and sacrifices. Several attempts to reform the economic system in 1967–70 were either not feasible or unsuccessful.

After 1975, lacking any better concept, Vietnam had to impose on the South the same model it had tried to reform. The deep economic and social crisis in the period between 1982–6 finally led to the abandonment of the centrally-planned model.

The third section describes the 20 years of *doi moi* (reconstruction), which began at a historical turning point in 1986. The *doi moi* process was immediately successful because of the introduction of market-economic principles, a domestic private sector and foreign direct investment. Regardless of the changes of the economic model, socialism as the final goal remained unchanged. The Programme of the Communist Party of Vietnam (CPV) in 1990 – still in place at the time of writing – nevertheless insisted that the state sector and the cooperatives sector should gradually but increasingly provide the foundation for the national economy. The debate on 'market economy with socialistic orientation' focused mainly on economic institutions but the reality showed that the state is an integral part of this concept. Without reforming the role, the function of state market institutions could be distorted.

After nearly twenty years of *doi moi,* from 1986 until now, the transition into a 'market economy with socialistic orientation' was an unprecedented success story but there is still a great deal more to be accomplished. On the one hand, Vietnam has achieved high economic growth and significant progress on the issues of democratization and the alleviation of poverty. International economic integration helped Vietnam to reform and liberalize its economic system as well as to develop its culture and education system. On the other hand, Vietnam's economic growth is below its potential and barely sustainable. The gap between Vietnam and the regional economies is still widening. Vietnam remains a low-income economy with substantial poverty and rapidly widening inequality. Market institutions have been not fully established and the government's functions have not yet been adapted to market economic conditions. Control and redistribution of personal income are limited. 'Transparency' and 'openness' are new ideas and could be implemented gradually. Government redistribution of incomes is weak. Rampant corruption, abuse of power because of vested interests, and incompetence create serious socio-economic challenges. Increasing social unrest in rural regions, pollution, poorly planned urbanization, and other similar problems require urgent solution. Political reform is clearly trailing behind economic reform. A state ruled by laws with three divisions of power under the leadership of one Party must be explored, and this third section of the chapter discusses some possible means by which to achieve a socialist-oriented market economy in Vietnam.

Socialism as an ideal and its historical evolution in Vietnam

Ho Chi Minh's initiative on Vietnam's way forward

Under French occupation and colonialism since the middle of the nineteenth century, several generations of Vietnamese have continued the fight for national independence in various forms; for example, with armed insurrections or by seeking assistance from Japan or China. Ho Chi Minh was the first Vietnamese patriot who studied Marxism and Lenin's thesis about colonialism during his stay in France and discovered in these documents the way to fight for national liberalization. In 1924, under the name of Nguyen Ai Quoc, he expressed explicitly his first attempt at thinking independently rather than simply following Marxism dogmatically. He wrote:

> However it is impossible to forbid to add 'historical foundation' to Marxism, new materials to what Marx could not have in his time. Marx developed his theory based on a certain philosophy of a certain history, but what is that history? It was the European history. And what is Europe? It is not the whole humankind. Nations in the Far East could contribute to the concept of socialism.

In 1925, he wrote on the status of the first revolutionary organization in Vietnam: 'The Principles of the New Economic Policies should be implemented in the economy of Vietnam', indicating that his concept was, rather, market-friendly and different to that of so-called 'war-communism'. The following years of revolutionary activities confirmed that Nguyen Ai Quoc was serious about his statement that he wished to explore his own way of creating national liberalization and socialism.

On 3 February 1930, in Kowloon, Hong Kong, he established the Communist Party of Vietnam (and not, as previously mentioned, the Communist Party of Indochina, as directed by the Komintern in Moscow). Also, he presented the fundamental Party documents based on national unity and specified that the first task should be the fight for national liberalization. This attempt was immediately declared to be 'nationalistic' and was rejected by the Komintern in Moscow, the Communist Party of Vietnam was renamed the Communist Party of Indochina and a new Party Programme was endorsed based on the Programme of the Komintern, a programme that emphasized class struggle. A more faithful envoy from Moscow, 28-year-old Tran Phu, was appointed as the General Secretary of the Communist Party of Indochina in that same year.

In 1945, after the August Revolution and having gaining power in Vietnam, instead of initiating a 'class struggle' and exercising the dictatorship of the proletariat, Ho Chi Minh, as President, proclaimed the Democratic Republic of Vietnam, associating Independence, Freedom and Happiness with the state's name. Obviously, Ho Chi Minh had adopted the ideas of Sun Yat Sen (*three min*) in this formulation. He established a government of 'national unity': he appointed Vu Hong Khanh, a leader of the opposition National Party (the Vietnamese version of the Kuomingtang in China), as Deputy Prime Minister and Foreign Minister; former Emperor Bao Dai, under the name Nguyen Vinh Thuy, as Advisor of the President; and he appointed several non-Party members such as prominent intellectuals and former mandarins to ministerial positions in his cabinet. On the personal initiative of Ho Chi Minh, in 1944 two political parties were established; the Socialist Party, targeted on intellectuals; and the Democratic Party aimed at the entrepreneurs and the middle class.

In 1946 during his first official visit to France, Ho Chi Minh was able to attract prominent intellectuals to leave a wealthy life in France and share with him the hardship of the resistance.

This government was clean and efficient, and could mobilize the people to fight for nine years, culminating with the victory in Dien Bien Phu. The concept of national unity was successfully implemented.

He called upon the industrial and commercial entrepreneurs in Vietnam to continue their business and promised his full support (letter dated 13 October 1945 to the Hanoi Association of Industrial and Commercial Entrepreneurs). The very first Constitution of Vietnam adopted by the first elected National Assembly in 1946 was the most progressive in terms of ensuring the basic freedom and rights of the people.

Between 1930 and 1954, when compared with the Vietnamese socialist dream, the Soviet Union was described as a paradise on earth where people could enjoy life at its best. The extremely difficult conditions experienced during the period of resistance had not allowed for serious theoretical preparation for a real socialist model or the methodology of socialistic reconstruction. Until 1953, Ho Chi Minh implemented efficient but peaceful measures, such as the reduction of land rent for farmers by 25 per cent on 13 November 1945, and the re-allocation of abandoned land to landless farmers. However, he did not conduct rigorous Soviet-style land reform: for example, from 1945 to 1953, in all 302,840 hectares of arable land were allocated to farmers; 150 per cent of the land subsequently redistributed by land reform (215,980 hectares).

In the international arena, the government of Ho Chi Minh gained official recognition from the Soviet Union and China only after Ho Chi Minh had met Stalin and Mao in 1950. After returning to Vietnam, Ho Chi Minh did not conduct further land reform and, in 1951, Ho Chi Minh renamed the Communist Party of Indochina the Party of Labourers of Vietnam; the Party of Laos and the Party of Cambodia were designated autonomous parties. These events could be the reason Moscow and Peking invited Ho Chi Minh for a second time in 1952, during the war.

After once more meeting with Stalin in Moscow and Mao Tse Dong and Chou En Lai in Peking in 1952, Ho Chi Minh was given the green light for land reform that had been requested from both 'big brothers'.

Along with a material supply of weaponry from the Soviet Union, and other basic necessities such as food, uniforms, and medicines from China for the resistance forces to fight against the French invasion, from 1950, Chinese advisers came and provided brotherly guidance, not only for the army but also in the strategic concept of socialism, as well as concrete policy such as the agricultural tax. Under the pressure of both Moscow and Peking, and under the direct guidance of Chinese advisers from 1952, without any basic economic and sociological studies on the real situation in Vietnam, the first experimental campaign of 'mobilizing the mass for reduction of land rent' (*phat dong quan chung giam to*) and 'land reform' (*cai cach ruong dat*) were initiated and implemented in the liberalized regions by methods of intense psychological pressure to 'fight' (*dau*) and unilateral 'accusation' (*to*). A highlight of the violent campaign, in 1953 in the Thai province of Nguyen, was the case of Mme Nguyen Thi Nam, an owner of a plantation who strongly supported the resistance and whose sons were officers of the People's Army, was declared to be the 'landlord' and was condemned to death, against the personal objection of Ho Chi Minh. Obviously, this blind copying of the Chinese experience found supporters in the CPV and could therefore gain the upper hand.

From that point, the policy of national unity advocated by Ho Chi Minh at the beginning of the revolution was tacitly and gradually replaced by a policy of 'class struggle' and 'socialist reconstruction'.

The implementation of socialism as a real concept

In 1954, after nine years of devastating war against the French occupation, North Vietnam's economy was totally destroyed. According to the Geneva Agreement of 1954 on Indochina, the 'liberalized' regions and the former French-'occupied' regions were administratively unified.

As peace returned to Vietnam and the economic recovery started, from 1953 until 1956 the efforts to implement 'socialistic reconstruction' – tested out in the liberalized regions since 1952 – were expanded to the whole of North Vietnam. In all, eight consecutive campaigns of 'mass mobilization for land rent reduction' and five campaigns for 'land reform' were implemented in 3314 communes affecting 10 million inhabitants, mostly farmers. As a result of this 'thunder and landslide like campaign' (*long troi lo dat*) 70,000 hectares of arable land, equivalent to 44.6 per cent of the total arable land in these regions, were confiscated and redistributed to almost 4 million farmers. However, a more accurate analysis shows that, in fact, most of the land had already been confiscated prior to land reform and, actually, the noisy and brutal campaign only confiscated 26.3 per cent of the land from the landlords. Under the guidance of Chinese advisers, in every commune a quota of the landlords – 6 per cent of the total population – had to be identified. As a result, a high proportion of innocent people, Party members, were wrongly and unjustifiably denounced as being landlords, and were mistreated, tortured, and killed (see Table 9.1).

As confirmed after the 'correction', more than 70 per cent of the accused were wrongly categorized and mistreated; their houses and all their property were confiscated.

For most of the so-called 'barbaric, hostile landlords', any correction of these mistakes came too late; they suffered from incurable physical and

Table 9.1 Landlords during and after land reform

	As landlord denounced in the LR (people)	Acknowledged as wrongly denounced landlords (people)	Share of wrongly denounced landlords (%)
'Barbaric, hostile landlord'	26,453	20,493	77.4
'Ordinary landlord'	82,777	51,480	62.0
'Landlord active in the resistance'	586	290	49.0
Big farmer	62,192	51,003	82.0
Total	172,008	123,266	71.7

Source: Dang Phong *et al.* (2004).

Table 9.2 Rice production, 1955–64 (thousand tons)

Year	Rice output
1955	3,303
1956	4,127
1957	3,859
1958	4,454
1959	5,056
1960	4,177
1961	4,393
1962	4,388
1963	4,112
1964	4,424

Source: Tran Van Tho *et al.* (2000).

psychological wounds and many of them were unable to survive. Hate, distrust and revenge dominated the population. Human traditions were brutally and abruptly destroyed.

After 1959, the farmers were forced to join the cooperatives 'voluntarily'. Untrained landless farmers were appointed to their leadership: widespread mismanagement, abuse of power, corruption and a lack of incentives for the farmers led to an extremely inefficient agricultural system. Rice production fell immediately, and this reduction could not be arrested despite massive government investment in irrigation and farming techniques (see Table 9.2 above).

The cooperatives failed to create an efficient system of agriculture.

Moreover, during the land reform campaigns serious political mistakes occurred: out of 3,777 party organizations, 2,876 organizations were overhauled (76 per cent); out of 17,800 party members, 15,000 were 'reshaped' (84.2 per cent). Competent, educated Party cadres were rooted out from 'higher' social classes and were replaced by illiterate or poorly educated 'landless farmers', who had been newly admitted into the Party during the land reform. The Party suffered enormous loss of prestige; the efficiency of the Party organization was reduced which resulted in partial paralysis.

Ho Chi Minh officially apologized to the nation, but the legacy of these mistakes lasts a long time and, to this day, it remains a bitter recollection in the memory of the people.

In the urban regions, 'socialist restructuring' included the enforced move of all capitalist enterprises into so-called 'state-capitalist joint ventures', a *de facto* form of nationalization. The *riksha* drivers and the artisans that produce handicrafts were forced into cooperatives. Opaque ownership rights and unclear management regulations led to the widespread abuse of power and the cooperatives become covert private enterprises with 'red hats'.[1]

The share of state-owned and state-capitalist enterprises increased from 17.9 per cent in 1957 to 44.6 per cent in 1965. All the existing 3,065 private enterprises at that point – of which there were 957 industrial, 314 transport and 1,714 trading enterprises with a total capital of US$ 21.967 million[2] – were successfully reconstructed. The share of cooperatives increased from 0.2 per cent in 1957 to 45.4 per cent in 1965; the share of the private, individual sector declined from 71.9 per cent in 1957 to 10 per cent in 1965 (see Table 9.3).

Fortunately, the socialist reconstruction in Vietnam desisted from the total eradication of the small, widespread household and family

Table 9.3 Structure of economic sectors in North Vietnam

	Socialist sector			**Private, individual sector**
	Total	**State-owned and state-capitalist**	**Collectivized and cooperative**	
1957	18.1	17.9	0.2	71.9
1960	66.4	37.8	28.6	33.6
1965	90.0	44.6	45.4	10.0
1970	91.4	40.3	51.1	8.6
1975	91.6	51.7	39.9	8.4

Source: Tran Van Tho *et al.* (2000)

subsistence economy. The operation of small private agricultural activities on the 5 per cent of the land for members of the cooperatives was accepted. This was so efficient and become one of the major sources of income for the members of the cooperatives. Also, the farmers could sell their produce from this 5 per cent of land on the market and earn 40 per cent of their income in the form of cash. The higher efficiency of this 5 per cent of privately-worked land compared with the low productivity of the 95 per cent of collectively cultivated land of the cooperatives, provided data with which economists and policy-makers could assess the efficiency of the cooperative model.

In the cities, the small private traders were subject to moral condemnation, legally prohibited from trading, and pursued by the administration, but they were never totally eradicated because they met certain real, existing needs of the people, needs that were neglected by those responsible for central planning; for example, rice or food for visitors, meat for sick children and so on. As an exception in Hanoi – and thanks to intervention from the highest level – some small private restaurants offering popular traditional delicacies such as noodle soup (*pho*) or shrimp cake (*banh tom*) were permitted to continue their limited business without being collectivized and, in that way, they were able to preserve their reputation.

Private capitalist enterprises were considered to be illegal and non-socialist. The central planning system did not allow the operation of any private enterprise outside the planned system. No materials were available and no credit was provided to private enterprises, if they existed. Moreover, there was social discrimination towards capitalist elements; not only did the capitalist entrepreneurs face a hard life, but also their children were barred from universities and faced huge difficulties when seeking employment. Capitalists and the bourgeoisie were condemned as enemies of the socialist society. The poor were considered as revolutionary, and the poorest were the most revolutionary of all. Exploitation was seen as a bad habit to be overcome. Only manual work was lauded as reflecting the honour of the people. Intellectual activities and professional services were seen as 'non-productive' and parasitic activities. In this systemic economic, social, political and moral context, capitalist elements could not exist. Moreover, their subsequent generation was also curtailed. Society was called on to work hard, restrain from material consumption and endure economic hardship and shortages for the promise of a brighter and more prosperous future. The ignorance of management skills as well as any intellectual occupations was one of the most fatal failures in causing systemic inefficiency.

Table 9.4 Food rations for monthly consumption in North Vietnam, 1963–89

Categories	Class of rations	Meat (kg)	Sugar (kg)
Special	A1	More than 7 (not specified)	More than 3.5 (not specified)
Minister and equivalent	A	6.00	3.00
Vice-minister and equivalent	B	5.00	2.00
General Director	C1	3.00	1.50
Dep. Gen. Director	C	2.00	1.00
Director	D	1.00	0.50
State employee	E	0.30	0.25
Special worker	DB	2.50	0.75
Hard worker	I	1.50	0.75
Worker	II	1.20	0.50
Light worker	III	0.30	0.35
Children 6 and under 6	TR	0.30	0.50
Children 7–16	TN	0.30	0.35
Population	N	0.30	0.10

Source: Dang Phong *et al.* (2004).

Affected by both a bad economic system and chronic destruction as a result of the war (1965–1972), living conditions were extremely difficult for the great majority of the population.

The impact of the war and the inefficiency of the economy – agriculture, handicrafts and industries – led to further draconian restrictions on consumption. The state provided rations of basic necessities at stable prices, but the supply was scarce and not sustainable. People, mostly children, suffered unprecedented hardship.

Despite significant aid and assistance from the socialist countries, the notorious shortage and imbalance between the demand and supply of basic necessities forced the government to implement a complicated hierarchical system of rationing. Table 9.4 above provides an overview of this system.

Rationing was initially applied to rice, in terms of quantity, quality and special shops. This system of rationing was further expanded to cover such items as textiles (3 metres per person per year); health care; housing; furniture; cars, motorbikes or bicycles; even tickets for soccer games. Instead of building up a society based on equality and justice, society had become stratified (according to Table 9.4, 14 strata) with extreme differentiation regarding every necessity; social behaviour was greatly distorted. An abnormal shortage situation had become institutionalized and continued long after the end of the war in 1975. Connections, discrimination and favouritism were widespread. Social values were substituted by cynical and blunt pragmatism. Whomsoever could obtain a job at the state-owned rice shop or selling meat could enjoy a higher standard of living than highly educated intellectuals. The abolition of this system in 1989 required enormous political courage and faced stern opposition from those in the privileged strata.

After the reform, in 1989 the rationing of tradable goods such as rice, meat and sugar was abolished; it was replaced with a normal trading system but other hierarchical strata and classifications relating to healthcare, housing and other privileges remain in place at the time of writing, albeit in different forms.

Because of shortages, the supply of the promised minimal amount of the ration could not sustained. The Sixth Party Congress of the CPV in 1986 admitted that the 'basic needs of the life of the people have not been ensured'.

A vast number of state-owned enterprises (SOEs) were created with the support and assistance of China, the Soviet Union and other European socialist countries. But management was inefficient; corruption and abuse of power were soon discovered in the SOEs and Vietnam began reform experiments for SOEs in 1967 in three state-owned enterprises. The experiments led to a short-term temporary improvement in the management but could not change the nature of the system of central planning.

In 1964, Kim Ngoc, First Secretary of the Party Committee of the Province of Vinh Phu, on his own responsibility, initiated a 'contract system' to overcome the shortcomings of the cooperatives. Regardless of the practical success, he was punished in 1968, suspended from his position due to 'serious deviation from the Party line'. In 1988, 24 years later, the General Secretary Nguyen Van Linh signed Resolution No. 10 of the Politburo, implementing, in principle, the concept that Kim Ngoc had initiated and which was the cause of his punishment.

Despite substantial investment in the economy, the growth rate of the economy was not high. In 1964, at the end of the first Five-Year-Plan, the Party acknowledged that the economy faced serious problems and was in need of reform. But bombardment by the US Air Force (August 1964–December 1972) destroyed most of the infrastructure and industries; therefore, any critical assessment of economic policy was no longer appropriate. The priorities of the war prevented Vietnam from continuing its efforts towards economic reform.

Nevertheless, in 1967, under heavy bombardment by the US Air Force, Pham Van Dong, the Premier at that time, presented a report on economic reform. However, he was unable to present it to the Politburo due to the escalation of the war. From 1971 to 1973, Pham Van Dong invited a number of high-ranking advisers on economic policy from the German Democratic Republic in the hope of improving the efficiency of the economy. Study groups were sent to Bulgaria and Hungary; however, the Soviets rejected any lessons learned from Hungary. All these efforts were still unable to produce any relevant reform in the framework of the model, but were helpful in training the Vietnamese policy-makers and SOE managers to be more open-minded and independent in their thinking. In that way, they indirectly prepared the *doi moi* process, which followed later.

In 1968, following the death of Ho Chi Minh, the First Secretary of the Central Committee of the CPV, Le Duan, published his own theoretical concept of 'collective mastership' (*lam chu tap the*), defining the way forward for Vietnam's development, based on a centrally planned system and state-ownership, and fostering the creativeness of the collectivised labourers. It was not possible for this concept to be implemented successfully.

On the political scene, no further non-Party members were nominated to the government, as had been the case under Ho Chi Minh's leadership. Moreover, among party members themselves, careful selection promoted cadres that came from working or farming stock, while those who originated from the middle class were sidelined.

Vietnam, on the one hand, badly needed materials and military assistance from the Soviet Union and China in order to continue the fight for national unification. On the other hand, Vietnam was not convinced by the Soviet model or by Mao's experience in China. In this situation, Vietnam could not take any steps to reform its own system that in any way deviated significantly from the orthodox line, as this could cause disagreement with these two important allies. The circumstances of the Cold War also prevented Vietnam from making serious theoretical preparations for its future: no information was available; no intellectual contact was permitted with the West; no discussion was allowed.

This situation continued until, in 1975, Vietnam unified the country without having found an efficient concept for development. The big question for policy-makers in May 1975 in Hanoi was which development model was required for the South and which model to apply to the whole country.

Initially, in December 1975 the 24th Plenum of the Central Committee of the CPV (Third Legislation) adopted a Resolution to continue with a market economy and private sector development in the South for a particular transition period. However, political development led to the Fourth Party Congress in December 1976 to unify the North and the South and to 'lead the whole country to socialism'. Ultimately, as an unfortunate necessity, Vietnam was compelled to impose on unified South Vietnam's economy an economic system that North Vietnam had found to be inefficient and inappropriate, a system it had tried to reform but was unable to finalize.

The effort to conduct 'collectivization in agriculture, handicrafts and socialist reconstruction in private industries and trade in urban regions' was not initially implemented by Nguyen Van Linh, the member of the Politburo in charge from 1976–7. Only in 1978, after Do Muoi took over this position, was this process rigorously implemented, using a similar concept as in 1956 in North Vietnam. Two major campaigns of socialist reconstruction were launched in South Vietnam in 1976 (Campaign X1) and in 1978 (Campaign X2). Between them, the campaigns generated 22,456 private enterprises (8,000 of which were industrial), with a total capital of US$ 800 and employing 250,000 workers.[3] The share of the state-owned sector, therefore, increased steadily, as shown in Table 9.5. At the end of 1985, the socialist reconstruction was officially declared as having been successfully accomplished throughout Vietnam.

An inverse correlation can be found between the increasing share of the state-owned sector and the GDP growth rate, as shown in Table 9.6.

The economic situation worsened rapidly: there was galloping inflation, living conditions deteriorated, a real socio-economic crisis was threatening the political system, but no reform could be initiated. Only the death of General Secretary Le Duan in 1985 and the election of his successor, Truong Chinh, could prepare the foundation for reform at the Sixth Party Congress in 1986. But implementation was very limited in the framework of the traditional centrally-planned model.

Only when the Soviet Union, under Gorbachev, refused to make any economic aid available and the supply of fuel, fertilizers and other

Table 9.5 Structure of economic sectors in unified Vietnam

Year	State-owned sector	Non-state sector
1976	27.7	72.3
1980	19.8	80.2
1985	28.0	72.0
1990	31.8	68.2
1995	40.2	59.8

Source: Dang Phong *et al.* (2004).

Table 9.6 GDP growth rate on fixed price

Year	GDP	Agriculture	Industries	Services
1977	105.3	100.7	113.2	104.9
1978	101.1	93.6	107.5	109.0
1979	98.2	103.3	95.4	92.4
1980	96.4	105.6	88.7	87.8
1981	102.3	104.3	99.9	100.7

Source: Dang Phong *et al.* (2004).

essential commodities from the Soviet Union could not be ensured in exchange for Vietnamese exports – even before the official collapse of the Soviet Union in 1991 – did Vietnam abandon the centrally-planned model and implement substantial macroeconomic market reform. The implementation of this concept was immediately extremely successful and convincing in practice; however, theoretical documents still retain, to some degree, the 'leading role of the state-owned sector', 'the dictatorship of the proletariat' and so on.

In retrospect, for Vietnam, Soviet-style socialism was a noble dream on paper but one that failed in reality. The efforts of Ho Chi Minh to follow a different approach were initially promising but could not last. The historic political constellation and conditions did not allow it to reach a happy ending; however, the validity of his concept remains. His ideas of democracy, freedom, national unity, persuasion rather than repression and physical liquidation still encourage Vietnam in further reform.

The premature attempt to enforce collective ownership; the neglect of economic incentives and ignoring the role of management; the overemphasis on violence and repression, even the physical liquidation of a section of society in order to seek wealth and happiness for others; the neglect of intellectual values, professional skills and cultural traditions: none of this led to a better life for all, as had been promised. The restriction of freedom to create business and the inhibiting of entrepreneurial spirit were counterproductive. For Vietnamese society, this implementation of a theoretical model rooted in Europe proved to be a costly exercise and a hard lesson to learn.

Twenty years of *doi moi*

The *doi moi* process introduced the most glorious period of development in modern Vietnam's history: high economic growth, rapid reduction in poverty, improvements in human development and so on. A new private sector emerged. Vietnam is an active member of ASEAN and APEC, and joined the WTO in January 2007. In principle, Vietnam's present path to socialism is much more likely to be successful than any previous attempts. Socialism is neither only nor mainly a matter of being a market-economy; it is an issue for the whole social and political system: reform in Vietnam has to include both of these elements.

In 1991, the Seventh Party Congress adopted a new Party Programme to build up socialism in Vietnam as a mixture of both the Ho Chi Minh ideology and the orthodox socialism model. Socialism was declared to be 'a society with a prosperous nation, a strong state, a democratic society in equity and civilization'. This aim could provide a broad-based platform for national unity, striving towards a bright future for the whole nation.

At the same time, the Party Programme and the Party Status, adopted by the Seventh Party Congress in 1991, specified six characteristics and seven fundamental orientations for a socialist society in Vietnam. The five characteristics are:

- a society where the working people are the masters;
- a highly-developed economy based on modern production forces and national ownership of the main production means;
- an advanced culture with deep national characteristics;
- a society where the people are liberalized from repression, exploitation and injustice; work according to their abilities and consume according to their worked contribution; enjoy a prosperous, free and happy life; and have the opportunities to discover their full personalities;
- a country where ethnic races enjoy equality, solidarity and mutual assistance for common progress;
- the development of friendly and cooperative relationships with all nations in the world.

The seven fundamental orientations are:

- To build-up a socialist state of the people, through the people and for the people, based on the alliance between the working class with the farmers and the intellectuals under the leadership of the Communist Party.
- To develop production forces, industrialize the country, build-up the material–technical basis of socialism by steadily enhancing social productivity and improving the living conditions of the people.

- To develop an economy with multiple economic sectors operating according to a market mechanism with socialist orientation, the state-owned and cooperative sectors providing, increasingly, the foundation for the national economy.
- To conduct the socialistic revolution in ideology and culture, with Marxism–Leninism and Ho Chi Minh's ideology as the guiding perceptions of the world.
- To exercise the policy of national unity.
- To construct socialism and to defend the Fatherland are two strategic tasks.
- To build up a Party that is clean, and strong in politics and ideology, as a leading force for the socialist revolution.

The Status of the CPV does not allow a Party member to participate in private, capitalist activities and exploitation; however, it could hardly define how to measure and define 'exploitation' and identify the border of 'capitalist private activities'. Principally, Vietnam has accepted a market-economy and international economic integration as the means by which to build-up socialism in a specific way that is still different, in several relevant areas, to international perception.

The questions are: How compatible is the aim with these means and orientations? Are there contradictory elements between these formulations?

Some practical challenges

1 After 20 years of *doi moi*, Vietnam has not yet accomplished its own agenda of reform and serious problems have emerged:
   - Market-economic institutions are not yet fully established and are far from functioning well. The stock exchange market is insignificant, being 0.26 per cent of the GDP; most of the largest state-owned General Corporation is not yet equitized; and the 2,240 small and medium-size, equitized state-owned enterprises share only 8 per cent of the total capital assets. Most of them are not yet listed on the stock exchange market. State-owned commercial banks have not been reformed. The labour and technology markets are not yet fully established. Corporate governance has been established, formally and nominally, but is far from functioning according to international standards. Transparency and openness are not generally applied. Public administration agencies are still heavily involved in business – especially in allocating

credit, investment and public procurement. Ownership laws and contract laws are unclear and are not well specified; they are fertile ground for the abuse of land, forestry and other state-ownership. The enforcement of legislation is still motivated by politics; agencies for legal defence are neither impartial nor independent. The economy is largely dominated by large state-owned monopolies with regard to airlines, telecommunications, basic commodities and services. There is no level playing field for the domestic private sector. State-owned enterprises enjoy privileges by seeking large public investment contracts, or public procurement, or access to land. Although several services are open to foreign investors, these are still closed to the domestic private investor (for example, telecommunication services). Reform in education, health care and insurance has been less well prepared and coordinated, leading to unjustifiable inequality and high costs for the poor. Human resources are the most precious assets of Vietnam but education and training programmes are outdated.

- Vietnam joined the WTO in January 2007 and has amended several laws and legal regulations. The experience of the first year of WTO membership showed that it was easier to change the legal framework on paper than in practice. Soaring real estate prices, inflation, cumbersome bureaucracy and corruption harm the competitiveness of Vietnam's economy.
- Despite tremendous progress, Vietnam is still a low-income economy and is not growing at its full potential. Vietnam is unable to mobilize its own domestic capital and use it efficiently; moreover, it cannot at present fully disburse the committed Official Development Assistance. FDI attraction is modest. There is no clear legislative regulation of state-ownership of the SOEs. Public investment employs a huge share of total investment but is highly inefficient. Allocation of public investment is strongly politically motivated and is scattered across an overly high number of projects. At low level of development and industrialization, environmental pollution is unnecessarily high. Under-employment in rural regions is high; migration from rural regions into cities with definitely higher incomes creates increasingly serious social problems. There are increasing problems with the newly poor farmers due to rapid urbanization and expanding industrial parks. There are rapidly increasing rates of HIV/AIDS and traffic accidents, and criminality requires systemic and coordinated solutions and actions.

- Unequal development across regions – especially with regard to the backwardness of remote areas – could create ethnic misunderstanding and conflict, which could lead to further social and political problems. Ethnic and religious issues must be analysed and solved using modern and realistic concepts. Low levels of income, in Vietnam have led to a state of high inequality: the Gini coefficient for consumption increased from 0.33 in 1993 to 0.35 in 1998, and 0.37 in 2004. The inequality in income must be even greater but has not yet been identified.

2 The government is less efficient with regard to the redistribution of incomes. Personal income taxes contribute only 1.87 per cent of domestic budget revenue and have mainly been generated from employees working for foreign direct invested companies (World Bank, 2003). The nominal salary of all state officials is below the level at which personal income tax becomes payable. Despite having a strong commitment to poverty reduction, the government is only able to provide a limited budget with which to achieve this. Enforcement of legislation is weak; there is a significant gap between the law on paper and the law in action. On the other hand, government agencies are still involved in land and credit allocation, influencing public procurement and so on.

3 Political reform is clearly falling behind economic need and social requirements. Officially, Marxism–Leninism and Ho Chi Minh's ideology remain unchanged as the unique guiding doctrines. A state ruled by legislation with three divisions of power under the direct leadership of one Party must be shaped and implemented. The whole political mechanism of the system must be further developed to meet the various challenges and realize opportunities; for example, on how to exercise the leading role of the Party, how to enhance the role of the National Assembly as the highest body of power according to the Constitution, how to make the government clean and professional, how to establish an independent and impartial justice system and so on. All these issues need solutions that are appropriate for Vietnam but also in line with international standards. The selection of Party cadres, the running for the various positions, the rights and responsibilities of the leading Party agencies: these must be regulated by legislation in the context of a market economy and international integration, in line with transparency and openness. The increasing desire for democracy, for sufficient information, for the participation of people in order to use their constitutional rights to fight against corruption, against the abuse of power: these are all part of the solution

but, on the other hand, they are subject to control and monitoring as a precaution against political instability. These problems must be set on the agenda and resolved in the interests of the internal stability of Vietnam. Special attention is required with regard to corruption as a phenomenon of the socio-economic system. Corruption has turned out to be a serious problem for economic competitiveness and social progress. Daily, rampant corruption on a small scale on transactions related to state agencies or public utilities – especially on matters related to credit, tax, custom and formalities regarding land, and also with regard to electricity, water supply or telephone services – creates frustration among the people and business enterprises. On the other hand, matters of large-scale organized corruption have been revealed relating to major state-owned corporations, quota allocation and so on. Corruption increases the inequality in an unfair way; it increases the cost of business transactions in terms of time and money, reducing the competitiveness of the economy at national and company levels and with regard to products and services. The fight against corruption has so far not been effective; there is general agreement and strong rhetoric on the need to fight corruption as a whole, but there is insufficient determination to fight corruption in specific, concrete cases.

How can a civil society emerge and develop; how can freedom of the press and freedom of expression help in the timely discovery of weaknesses and failures, and motivate everyone to find appropriate solutions and implement them? If the 'market-economy with socialist orientation' could find an efficient model with which to release the energy, the strengths and the creativeness of the Vietnamese people – both in Vietnam and overseas – Vietnam could achieve further progress.

Could a market-economy with socialist orientation in Vietnam follow the model of the Nordic economies such as Sweden? Could it develop its own model, fostering a prosperous economy that demonstrated democracy, equality, and civilization? Future development will answer this question, and the ideas of Ho Chi Minh are still helpful in this endeavour.

Notes

1. 'Red hats': popular slang meaning 'in the guise of an alleged socialist cooperative'.
2. This figure for capital was deliberately under-estimated. Machines, equipment and raw materials were assessed without the owner. Land and real estate were

not fully included. Prices were fixed administratively at far below the real value. The methodology for socialist reconstruction in 1957–8 in the North and 1976–8 in the South was similar.

3. As compared with the period 1 January 2000 to the end of December 2004, when more than 120,000 new private companies with a total capital of US$ 13 billion have been registered.

References

Communist Party of Vietnam, 'Documents of the Party, Party Program, Party Status' (Hanoi: National Publishing House for Political Literature Su That).

Dang Phong (2004) *History of Vietnam's Economy, Volume II, 1954–1975*, Unpublished draft.

Ho Chi Minh (1977) *The Status of the Revolutionary Youth Association, The Pre-Party Organisations* (Hanoi: Central Commission for Party History) (Vietnamese).

Ho Chi Minh (1980) *Collected Works. Volume 1. Report on the Situation in Tonkin, Anam, and Cochinchina* (Hanoi: National Publishing House for Political Literature Su That): 464–9.

Le, Duan (1968) *Under the Glorious Banner of the Party* (Hanoi: National Publishing House for Political Literature).

Tho, Tran Van *et al.* (2000) *Vietnam's Economy 1955–2000. Newly Calculated Statistic Data* (Hanoi: Statistic Publishing House).

Tung, Hoang (1998) *From Traditional Thinking to Ho Chi Minh's Ideology* (Hanoi: National Publishing House for Political Literature).

World Bank (2003) 'Vietnam Delivering on its Promise. 2003', Vietnam Consultative Group Meeting, Hanoi, 10–11 December 2002.

10

Economic Reforms in Vietnam: What Lessons can be Learnt?*

Vo Tri Thahn

Introduction

After the reunification in 1975, Vietnam shifted its focus on reconstruction and socio-economic development. The failure of economic development followed closely the centrally-planned model that forced Vietnam to undertake microeconomic reform in the early 1980s. However, only the *doi moi* (renovation) in 1986, and especially the radical market-oriented reform of 1989, marked a turning point in the history of Vietnam's economic development. As other economies in transition, Vietnam has had to deal with three key sets of reforms: liberalization and stabilization; institutional changes that support market exchange and shape ownership; and the establishment of social programmes to ease the pain of transition (World Bank, 1996). Vietnam's reform process has also been uneven. It was recognized even in 1996 that the reforms were limited and were not keeping pace with economic development. Moreover, the reform process in general slowed down during the period 1996–99, especially after the Asian crisis. The years 2000–4 witnessed new commitments to the continuation of reform and some progress was made, especially in the development of the private sector and trade liberalization. Meanwhile, the reform of state-owned enterprises (SOEs), the banking system, and public administration were slower than expected, and this has limited the effectiveness and efficiency of other reforms.

Since the 1989 reforms, the face of Vietnam's economy and society has changed significantly. Vietnam has recorded remarkable achievements in terms of GDP growth, macroeconomic stabilization, export expansion and poverty reduction. It is now generally recognized that Vietnam is among the best developing countries in terms of achieving relatively high economic growth and reducing the incidence of poverty.

At the same time, some have argued that in international comparisons Vietnam's performance is not so spectacular and, moreover, there remain many problems with regard to sustaining economic growth and ensuring quality of development.[1]

This chapter is about the economic reform process in Vietnam. The experience of Vietnam is worth examining in order to enrich our understanding of the underlying political and economic determinants of transitional and developmental process. This is also helpful to Vietnam in order to implement more effectively its Comprehensive Poverty Reduction and Growth Strategy (CPRGS).[2]

The remainder of the chapter is organized as follows. The next section briefly highlights the process of economic reform and its socio-economic achievements in Vietnam. The chapter goes on to mark the salient features of and the key lessons that can be learnt from the reform process. The subsequent section considers the major challenges facing Vietnam's efforts to achieve the ambitious targets set in Vietnam's socio-economic development strategy and the perspective of Vietnam's further reforms.

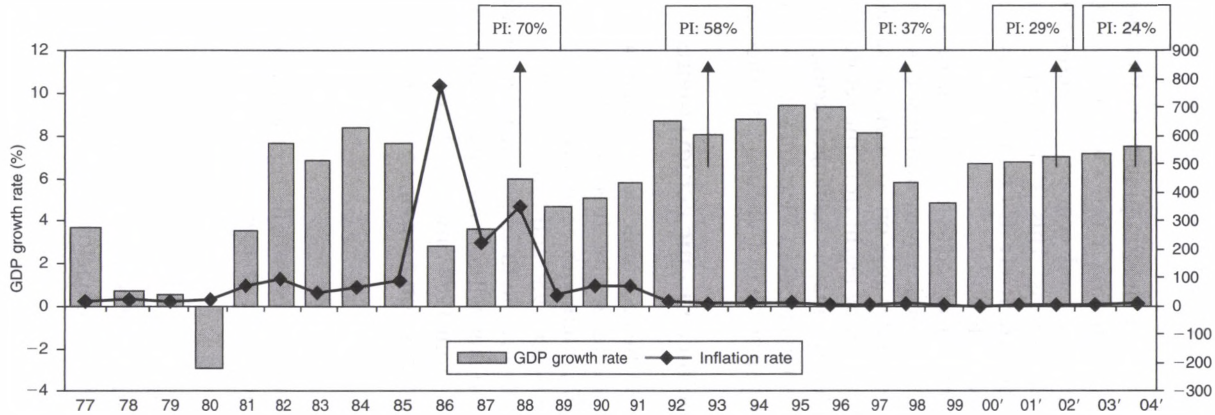
Economic reforms and socio-economic achievements[3]

Since the reunification in 1975, the economic development and policy changes in Vietnam can be characterized by three periods (Figure 10.1). In Period 1, prior to the 1980s, Vietnam's economy was essentially a centrally planned economy. Between 1980 and 1988, Period 2, the economy can be regarded as having been a modified-planned economy where some micro-reforms were undertaken without any significant change in macroeconomic management. From 1989 onwards, Period 3, the economy has been an economy in transition,[4] striving for industrialization and international integration.

Period 1: before the 1980s

During this period, the economy was essentially centrally planned and at a low level of development. Major characteristics of the economy included:

- state or collective ownership of production means;
- government administered supply of physical inputs and outputs;
- lack of business autonomy, absence of factor markets, highly-regulated goods and services markets;
- a bias in investments towards heavy industry, which were overwhelmingly dependent on external sources.



Up to 1980s: Centrally-planned economy	**1980–8**: Modified-planned economy. - 1980–1 and 1987–8: Some micro-reforms and price adjustment - 1985: The 'price-salary-money reform' and its failure	**Since 1989**: Market-oriented reforms	**1996–9**: Slowdown of reform process	**Since 2000**: Stronger commitments to further reforms, but with their uneven implementation

Figure 10.1 Vietnam: landmark reform, economic growth, inflation, and poverty reduction, 1976–2004

Note: PI = Poverty incidence.

Source: Data of economic growth, inflation and poverty are provided by the General Statistics Office (GSO) and our assessment of the reform process.

Vietnam was relatively autarkic, trading mostly with the former socialist countries. As a result, the economy was heavily distorted in terms of resource allocation, with poor incentives and restricted information flows. By the end of the 1970s, the failure of the centrally-planned system had become apparent and pressures for economic management change increased substantially.

Period 2: 1980–8

During this period, the centrally-planned economy was modified to respond to depletion of the economy. Some microeconomic reforms were introduced in 1981 to recognize and legalize spontaneous measures, such as 'illicit contracting' in agriculture and 'fence breaking' in the manufacturing sector. These micro-reforms enhanced voluntary and decentralized interactions between individual agents and created new incentives for producers in raising outputs during the period 1982–5. The economy became more dynamic and, as a result, Vietnam enjoyed a high rate of economic growth in the first half of the 1980s (Figure 10.1). However, growth was not sustainable and tended to decline as a result of macroeconomic imbalances such as excessive demand for consumption goods and a huge fiscal deficit. The financial reform implemented in 1985 in an attempt to reverse the situation also failed as it was introduced without addressing the fundamental problems of resource misallocation and macroeconomic imbalances in the economy. In the mid-1980s, the inflation rate accelerated to several hundred per cent.

The Sixth Party Congress in December 1986 recognized the existence and the essential role of a multi-ownership structure in Vietnam's economy. However, significant changes in this direction occurred only sometimes after the approval of the *doi moi* (*renovation*) programme by the Congress.

Period 3: March 1989 and onwards

During this period, Vietnam adopted a radical and comprehensive reform package aimed at stabilizing and opening the economy, and enhancing freedom of choice for economic units and competition so as to make fundamental changes to its economic management system. The reforms included:

- almost complete price liberalization;
- large devaluation and unification of the exchange rate;
- increases in interest rates to positive levels in real terms;
- substantial reduction in subsidies to the SOE sector;

- agricultural reforms through replacement of cooperatives by households as the basic decision-making unit in production and security of tenure for farming families;
- encouragement of the domestic private sector and foreign direct investment (FDI);
- removal of domestic trade barriers and creation of a more open economy.

Macroeconomic stabilization was successful in conjunction with price liberalization, the changes in interest rate and exchange rate policies and, at the same time, the relief of the fiscal burden. Monetary policy has also improved and the use of changing monetary instruments has become more effective in cutting down inflation.

Several measures to increase the private sector participation in production and distribution have been taken, including creation of a legal framework for private business. Agricultural reforms, together with the recognition of the farming household as a basic economic unit and long-term land use rights provided by a new Land Law in 1987 and Amended Law in 1993 created strong incentives for farming households to make long-term investment and expand agricultural production. Agricultural production has become much more diversified under market and foreign trade development. The reform of the agricultural sector was essential to poverty reduction as it provides income to some three quarters of the population.

Rapid growth in services and construction during the 1990s mainly came from a quick response by private entrepreneurs. Almost 2 million newly established household businesses in urban areas helped to enhance the performance of the economy and make considerable improvements in the retail sales and service network. During the 1990s, about 45,000 private enterprises were registered under the Law on Private Enterprises and Company Law approved in 1991. The private sector became a major source for employment in the economy.

In an attempt to make the operation of the SOEs viable, the government has substantially reduced subsidies, diminished 'cheap' credit to these enterprises and given them greater autonomy. Furthermore, inefficient and money-losing enterprises have been liquidated. From 1990 to 1994, the number of SOEs fell from 12,000 to 6,300 and, out of the 4.05 million total SOE employees, 1.5 million SOE workers retired or were converted to part-time workers. These reforms led to some positive improvement in the growth performance of the SOE sector in the first half of the 1990s.

Vietnam has substantially liberalized its trade and investment policies since the late 1980s. In an attempt to integrate its economy with the rest of the world, Vietnam has entered into trade agreements with about 60 countries and has trade relations with some 170 countries. It has implemented a preferential trade agreement with the European Union since 1992. In addition, Vietnam has been a member of the Association of South East Asian Nations (ASEAN) since June 1995 and the Asia Pacific Economic Co-operation (APEC) since 1998.

Liberalization of the investment climate resulted in rapid growth in foreign investment between 1993 and 1997. The country received foreign investment from some 60 countries. The Law on FDI promulgated in 1987, and subsequent amendments, enabled Vietnam to attract a large volume of capital to renew technology and expand the markets. FDI has, indeed, become an integrated part of the Vietnamese economy and an important factor in Vietnam's economic growth during the 1990s.

To facilitate the development of trade and investment, the government also introduced reforms in the banking sector. The mono-banking system was replaced by a two-tier system, which could function in 1990, when the laws on banking authorized the State Bank of Vietnam to assume traditional central bank functions, such as the conduct of monetary policy and the supervision of the financial system. Also, sectoral restrictions on specialized banking activities and entry barriers were abolished. In addition to the five state-owned commercial banks (SOCBs), a number of joint-stock banks, credit cooperatives/funds, joint-venture banks and foreign banks are in operation in the country.

Despite broad and rapid liberalization, it was recognized that significant restrictions remained; for instance, in the areas of trade and market entry. The reforms of SOEs and the financial sector have been limited and have not kept pace with economic development. There has also been a deep concern with regard to the question of sustainable economic growth and development, especially during and after the Asian crisis in 1997–8. The challenges and difficulties facing Vietnam had called for further renovation processes. However, in general during 1997–9, Vietnam was still reluctant to undertake a decisive and comprehensive reform programme. The years 2000–4 witnessed the implementation of the demand stimulus policy to revitalize the economy and the new commitments to reform continuation.

The demand stimulus policy included several measures – such as public investment in infrastructure projects, financial support for SOEs to deal with their increasing inventories, budget injection to poverty reduction programmes, raising wages and salaries, encouraging people to consume, and partially supporting enterprises to expand exports. This package of demand stimulus policies had a positive impact on the economy, minimized the deflation situation and economic stagnation, but it was partially contrary to the process of structural reform and administration reform.

Since 2000, a surge in development of the private sector can be observed thanks to the implementation of the New Enterprise Law. During 2000–June 2004, about 90,000 private enterprises were registered under the new legislation, with total capital equivalent to about US$ 13 billion. (This figure is much higher than the FDI inflows during the same period. It is also five times higher than that of those private enterprises established during 1991–9). The remaining problems are of the creation of 'a level playing field' for business activities in practice. The remaining obstacles to the development of the domestic private sector are an uneven playing field, difficult access to resources such as land and credit, and state-enterprise monopoly in some key sectors. There have also been some improvements in the environment for FDI attraction (Amendment of Foreign Investment Law in 2000). But major obstacles still exist – such as cumbersome administrative procedures and corruption, an inconsistent and barely transparent system of legal documents, and the high cost of infrastructure services facilitating business.

The pace of reform of SOEs and the banking sector, however, remains not as rapid as expected, although there were the Party's Resolution on SOEs and the Overall Programme for the restructuring of the commercial banking system. In the period 2003–5, 3,000 SOEs from about a total of 5,000 SOEs were scheduled to restructure, of which 1,459 SOEs would be restructured in 2003 (but the number of transformations fell far short of the target; only 945 enterprises (or 62 per cent) out of the planned target were completed. In 2004, despite the efforts to accelerate the transformation process, including the equitization of some General Corporations and state-owned commercial banks, there was still no significant improvement. In the first 8 months of 2004, the number of equitized SOEs accounted for 35 per cent of the target, or 350 out of 1000. The enterprises under the transformation programme account for only 24 per cent of SOE employment, 14 per cent of capital and 3 per cent of debt. The fragile banking sector remains a major concern with high non-performing loans, a high risk of expansion of credit to sizable and high-cost projects.

A trade policy roadmap for the period 2001–5 (Decision 46/2001/QD-TTg in April 2001) was announced for the first time in place of the earlier practice of announcing one-year regimes, making a more transparent and predictable export–import environment. Trade reform in some areas has been undertaken faster than the planned schedule; for example, the extension of trading rights to all economic sectors; the removal of some quantitative restrictions and export focal points; and so on. The international economic integration process has been stepped up. Vietnam has mostly fulfilled its commitments under AFTA.[5] Among the ASEAN countries, however, Vietnam still has the highest number of items in the Temporary Exclusion List (TEL) and in the Sensitive List (SL). The Vietnam–US Bilateral Trade Agreement (BTA), signed in July 2000 and coming into effect in December 2001, covers commitments in a wide range of issues that are in conformity with WTO norms – such as trading rights, tariffs, quantitative restrictions, intellectual property rights, liberalization in some service sectors, trade-related investment measures, and transparency. Recently, Vietnam has also joined regional integration clubs such as the ASEAN–China Free Trade Area and the ASEAN–Japan Comprehensive Economic Partnership. Vietnam's effort to be a WTO member came to fruition in November 2006.

The pace of administrative reform has still been slow and it seems that a breakthrough in this undertaking has not been found. The years 2002–4 were set as the years for correction of rules and discipline in the administrative system but only limited results were achieved. Administrative reform is to be considered as a central task for the coming years.

Renovation in 1986, and especially the market-oriented reform of 1989, marked a turning point in the history of Vietnam's economic development. Vietnam escaped from crisis in the mid-1980s and the face of Vietnam's economy and society has changed significantly. By 1989, inflation was under control and, since then, it has remained at a low rate.[6] From 1990 to 1997, the GDP growth rate was maintained at around 8 per cent per annum, on average. The GDP growth rate, however, went down between 1997 and 1999, partly because of the Asian financial crisis, and partly because of the dissipation of reform effects. Since 2000, the economy has regained its rather high growth rate at 7 per cent and more per annum (Figure 10.1).

Successful economic development has resulted in overall improvement of people's welfare and significant poverty reduction, irrespective of measurement methods. Total poverty incidence declined from about 70 per cent at the end of the 1980s to 58 per cent in 1993, 37 per cent in 1998 and further to 24 per cent in 2004 (Figure 10.1). Vietnam has also achieved notable results in human development. There has been a significant increase in Vietnam's human development index (HDI) (from 0.623 in 1994 to 0.688 in 2001) and, correspondingly, Vietnam's rank has improved from 121 to 109. In 2001, Vietnam ranked fifth among the ASEAN countries (after Singapore, Malaysia, Thailand, and the Philippines).[7]

Nature of reform process and lessons

The achievements in Vietnam can be attributed to four key factors:

1. the acknowledgment of the private business right;
2. the market-oriented reforms;
3. the opening (mostly in terms of trade and FDI) and the integrating of the economy into the regional and world economy; and
4. the keeping of macroeconomic and social stability.

These factors have motivated economic behaviour changes and, once they are gradually locked-in, it will be very difficult for Vietnam to return to the previous economic management system. In nature, the economic reform process is to grant rights and to enlarge opportunities for people in choosing and deciding the direction and form of their production and business activities.

There are several interrelated lessons that can be drawn from Vietnam's experience:

- First, the effective reforms require both political will and changes in the way of thinking that reflects the dynamics of real life. As mentioned before, the microeconomic reforms introduced in the early 1980s, in fact, recognized and legalized the people's spontaneous measures to operate outside the plan, so they can be seen as 'bottom-up' reforms. The failure of the efforts to stabilize the economy up until 1989 and of the last attempts to control the free market during the period 1985–8 as well as the drying up of aid from the former Soviet Union had created immense pressure on reform. The slogans 'Let markets be untied' and 'Rescue yourself' reflected the nature of the radical reform package in 1989.
- Second, since Vietnam is an agrarian economy[8] in transition, where economic policies and implementation procedure are still a legacy of a centrally-planned economy, the approach to and the way of reform implementation are essential for ensuring success, while keeping social and political stability. The 'bottom-up' reforms first launched in rural areas might be easier, as they satisfied the people's willingness, and the political situation in rural areas was seen to be less complicated than in urban areas. In general, economic reform in Vietnam

has been a process of 'learning by doing' and characterized by *gradualism*. This approach has several advantages since it should avoid the crisis/collapse of the economy, while gradually gaining the confidence in and the support for reform as the people see the successful outcome of reform.

- Third, the selection of reform approach is not only driven by the targets reform should achieve, but it is also based on the structure of existing institutions. In a broader view, it can be seen that underlying Vietnam's (and China's) reforms is a series of institutional changes in the novel forms of transitional institutions. These institutions work because they achieve two objectives at the same time – they improve economic efficiency, on the one hand, and make the reform a win-win game and interest compatible for those in power, on the other hand. These institutional reforms are not created 'solely for increasing the size of the pie, but also reflecting the distributional concerns of how the enlarged pie is divided and the political concerns of how the interest of those in power are served' (Qian, 2001).
- Fourth, pursuing the approach of gradualism does not mean that the focus should be, at first, solely on the reforms at microeconomic levels. Vietnam's experience has shown that the partial and sectoral reform measures might be good but not good enough. They should be undertaken within more comprehensive reforms, especially in conjunction with macroeconomic reforms and the opening of the economy.

The economic reform process in Vietnam, however, has not been smooth. As can be observed, the policy measures implemented in some cases have not been sufficiently comprehensive and/or inconsistent with market-oriented reforms; during the process of integration, even Vietnam recognized the serious weaknesses of its economy. A main reason, of course, is rooted in a legacy of a centrally-planned economy, which, in reality, is reflected in the ways of directing and controlling the resources, especially capital allocation, and dealing with the SOE sector.

The explanation can also be seen in other ideological, economic and social factors. The Communist Party leadership has been considered a most decisive factor for guiding the *doi moi* process and ensuring its success. The Party, on the one hand, has recognized the fundamental ideas of Marxism–Leninism and Ho Chi Minh's ideology as being a compass needle for its general guideline. On other hand, the Party has seen the need to have a new approach to their interpretation and application, so that its leadership can effectively adapt to the new environment of a market and more open economy. This could only evolve gradually and naturally has had a complex impact on the economic reform process. For instance, Vietnam has accepted the necessity of a market mechanism but, at the same time, it should be 'under state management' and/or 'by socialism orientation'. In Vietnam, the concept of 'socialism orientation' is often approached via three dimensions:

- The first dimension is based on an assessment of the role of the state sector, which is thought to play a leading role in the economy. In fact, GDP growth has still been heavily dependent on the SOEs' performance and driven by state investment, a tendency that seems likely to continue in coming years.[9] However, both state investment and the SOE sector have been recognized as inefficient, and corruption has been widespread in connection with state investment.
- The second dimension is very much associated with the problems of ownership – especially that of production factors – and income distribution. One concern is that the over-developed private sector would lead to exploitation. There is also a concern about social problems, such as the gap between the poor and the rich, and social stability in the process of economic international integration and SOE reform. As a result, it is hard to create, in practice, 'a level playing field' for all institutional economic sectors, and the reform process has sometimes been characterized by 'stop-and-go' policies.
- The third dimension is more or less directly attached to the goals of development, meaning that development is for the people, by the people, and of people, and Vietnam needs to strive for 'a rich people, a strong nation, and an equal, democratic and civilized society'. This approach, though it sounds beautiful, did not have much in the way of concrete policy guidelines.

Moreover, the concept of 'socialism orientation' is sensitive to the changes and development in the region and in the world. For example, the intense arguments for and against globalization could heavily bias the approach to reform towards the political and social conceptual realities in Vietnam, emphasizing the dangers of global markets. In fact, the East Asian crisis and the socio-political turbulence in some countries were seen differently in Vietnam. While many have maintained that the crisis has simply reinforced the importance of further reform, others have emphasized the dangers of exposure to global markets in terms of social stability and sovereignty (Vo Tri Thanh, 2000).

Finally, there is the problem of asymmetry in incentives for those supporting or opposing reforms, depending on whether they will be winners or losers. For instance, in general, most people will benefit from the reduction of trade barriers, while the inefficient and highly protected enterprises will have difficulty surviving in the new market environment. A complex package of reforms means the involvement of many participants with different motives. Benefits for the many are merely potential gains without certainty and, therefore, reactions might not be concerted and strong. Whereas, for those with vested interests, the loss of benefits through reduced protection and limited public advantages is real, they are still in a position to influence the decision. This, somehow, can be seen in the case of Vietnam, where the administrative way of managing the economy has created close, mutually beneficial connections between the line ministries and the SOE sector as a whole, and the State General Corporations in particular. The problem of conflict of interests is difficult to attack effectively since the vested groups can use the same political and social arguments just mentioned to justify the de facto status.

Interestingly, it is not possible to understand economic reform in Vietnam without examining carefully the 'turning points' associated closely with the significant institutional changes. A remarkable example is the reform of 1989. Vietnam's radical reform package, launched in 1989, was the exception in the context of gradualism, for its outcome was very different in comparison to the experience of many transitional economies in Eastern Europe, although the liberalization and stabilization measures used were similar to these economies (Riedel and Comer, 1997). The gradual approach did not seem to work well in Vietnam until the 1989 reform was launched. The launch was circumstantially forced into being under the pressures of an economy in macroeconomic instability, crisis and the 'drying up' of aid from the former Soviet Union. Surprisingly, its outcome was very impressive, although it was implemented without the technical and financial assistance of international institutions. So far, the economic reform package in 1989 is considered to have been most successful since it created the basic conditions for the transformation into a market-oriented economy.

Since about 1999–2000, several structural weaknesses and vulnerabilities of the economy have been widely recognized by Vietnamese policymakers. The pressure for more decisive and comprehensive reforms has been strengthened as Vietnam's process of international integration become more deeply embedded. In this context, some researchers mentioned the necessity of implementing the so-called 'second wave' of reforms as another 'turning point' for ensuring high economic growth and sustainable development in Vietnam.[10]

Challenges ahead and reform perspective

The dream and expectation of Vietnam to be a civilized society and an industrialized country have always been the focus of its development strategy. In the past, however, Vietnam failed to bring its dream into reality, mainly because it pursued a centrally-planned system – an institution lacking incentives and efficient resource allocation. With the renovation (*doi moi*) and market-oriented reforms, Vietnam has not only entered a new stage of development, but also had a good opportunity to succeed in industrializing and modernizing its economy.

The development objectives of Vietnam over the first two decades of the new millennium are quite ambitious. Vietnam expects to sustain high economic growth and to escape the status of a poor country by 2010. The overall goal of Vietnam is to accelerate industrialization and the modernization process in order to bring the country out of underdevelopment and create a foundation so that, by 2020, Vietnam will basically become 'a modern-oriented industrialized country'.

However, Vietnam is currently facing great challenges. Vietnam is still a low-income economy in transition striving for industrialization in order to catch up with more advanced economies in the region. While Vietnam has recorded remarkable achievements in socio-economic development, imbalances in growth have emerged. The economy has recently exposed weaknesses and vulnerabilities in several areas – such as in the SOE sector, the financial system, public investment, and the education and training system. The problem of poverty and income inequality also adds to the risk of socio-economic instability, which could stall economic development. Vietnam should benefit substantially from its trade liberalization and economic international integration. But the existing problems and weaknesses could be exaggerated as the economy integrates deeply into the regional and world economy. The adjustment costs, especially in the short-term, during the integration process could also be significant.

At the same time, the reform process in Vietnam now becomes more complicated and difficult for the following reasons:

- First, Vietnam needs to develop a market-based institution dealing with production factor (capital, labour, land) markets, the SOE sector, and the financial system, many aspects of which are related to the concept of 'socialism orientation' and the way of thinking, policy-making and resource allocation still rooted in the legacy of a centrally-planned economy.

- Second, the reforms should be consistent with the process of international integration. It is no exaggeration to say that the reform process in Vietnam is very much an international commitment-based reform process.
- Third, economic reform, administrative reform and political reform need to be implemented in a more synchronous manner. Obviously, this is very much dependent on the will, determination and accountability of Vietnamese leaders as well as the feedback by and the participation of the people.

At the same time, the current domestic situation in Vietnam and the external environment have changed significantly. The questions now are: How can Vietnam have more pro-active and effective reforms in response to these changes, and what is the perspective of the implementation of further reforms?

Three scenarios seem to be possible (Vo Tri Thanh, 2000). The first is characterized by a slow process with a still heavy legacy of a centrally-planned economy, especially in dealing with the SOE sector (including the commercial state-owned banks) and the allocation of state investment funds. The second is also a gradual and incremental process, but one that is consistent with market reforms and international integration. The third is the implementation of further decisive and comprehensive reforms.

The first scenario was already seen in the policy changes over the period 1996–9. The reforms during 2000–4 more or less followed the second scenario, but the measures used for protecting high cost and import substituting industries as well as the abuse of public investments were substantial. This means that the factors in favour of the first reform scenario are still strong. Moreover, Vietnam is not now in a crisis situation, as was the case with the 1989 reform, and, therefore, the pressure for radical policy changes might be low. In spite of this, the timeframe for 'bad' policy manoeuvre is reduced by the forced implementation of the existing commitments to reforms and international integration and the accession to the WTO. In addition, the gradual approach to reform had certain advantages, but also several disadvantages, because the reform could be characterized by stop-and-go steps, inconsistency with business cycles, unpredictability in the investment and business environment, and possible conflict between central and local authorities.

To a significant extent, this approach might be not appropriate in the new context of international integration and globalization. The implementation of a consistent reform process (the second or, better, the third scenarios) becomes increasingly realistic.

Vietnam's further reform and development programmes seem to include the following key components:[11]

- institutional reform (reform of the legal framework and public administration, and the strengthening of enforcement and people's participation);
- improvement of macroeconomic policies in conjunction with trade liberalization and gradual opening of the capital account;
- structural reform, especially reform of the SOE sector and the financial system;
- private sector development and attraction of efficient FDI;
- agricultural and rural development;
- radical reform of the education and training system.

Overall, the reform of economic institutions and human resource development should be priorities for policy implementation. The first and foremost factor for overcoming the obstacles on the road to prosperity for Vietnam is to change the still state-led economic institutions into efficiency-enhancing institutions with greater participation of the people. The limitations and constraints in institutions also mean that there is considerable room for Vietnam to change in order to create an incentive environment for advancing, and even leapfrogging, in the industrialization and modernization of the country. The institutional changes, together with the formation of skills, will be a very effective insurance measure. This is because it enlarges both the set of choices by people and their capability to exploit benefits from these new choices. As a result, the people become less vulnerable to changes in the economy and society.

Notes

* This chapter is based on a paper presented at the International Economic Association Round Table on 'Market and Socialism Reconsidered', Hong Kong University of Science and Technology, Hong Kong, 14–15 January 2005. The opinions expressed in this chapter rest exclusively with the author and do not necessarily reflect the views of his organization, the Central Institute for Economic Management (CIEM).

1. See, for example, Dapice (2003). Vietnam also recognizes that economic growth during 2000–04 was under its potential and the competitiveness of the economy is quite low.
2. See SRV (2004) and World Bank (2003).
3. This section is primarily adapted from Vo Tri Thanh and Pham Hoang Ha (2004).
4. The IX Party Congress (April 2001) confirmed that Vietnam is building and developing a market economy by socialist orientation.
5. During 2001–03, nearly 2000 items were transferred from the Temporary Exclusion List (TEL) to the Inclusion List (IL), increasing the number of items in the IL to 10,143 (or 97.1 per cent of total tariff lines compared to that of about 39 per cent in 1996). The maximum tariff rate of the items in the IL has been reduced from 50 per cent in 2000 to 20 per cent in 2003, and it is to be further lowered to 5 per cent in 2006.
6. In 2004, inflation rate (measured by CPI) increased considerably, to 9.5 per cent from the low rates during 2000–03.
7. See UNDP (various issues). Note that the higher the HDI of a country is, the better its human development is evaluated.
8. Agriculture's share of GDP gradually reduced from 40.5 per cent in 1991 to 22.3 per cent in 2003. Over the same period, the share of GDP accounted for by industry in general, and by manufacturing in particular, increased steadily, from 23.8 per cent to 39.9 per cent, and from 13.1 per cent to 20.7 per cent, respectively. The service sector reached its maximum contribution to GDP of about 44.1 per cent in 1995 and then declined continuously to 37.8 per cent in 2003. Several high value-added and professional services are still underdeveloped, hence limiting the improvement of the economy's competitiveness (Vo Tri Thanh and Pham Hoang Ha, 2004). At present, about 74 per cent of the population are living in rural areas and they account for 65 per cent of the labour force.
9. At present, the SOE sector accounts for about 30 per cent of GDP and state investment (including state budget investment expenditure, state credit and owned outlays by the SOEs) accounts for more than 50 per cent of total investment.
10. See, for example, Kokko (1999) and Vo Tri Thanh (2000).
11. As shown in the Resolution of the 9th Plenum of IX Central Committee of Communist Party of Vietnam in January 2004, Vietnam has committed strongly to further economic reform programmes, which include the following components (CPV 2004):

    - To continue reforming the SOE sector and improving its efficiency with the focus on further equitization; to encourage the development of cooperative, private and foreign invested sectors; to strengthen the competitiveness of enterprises; to improve the efficiency of investments by state budget.
    - To establish and to develop the production factor markets simultaneously.
    - To continue pro-active integration; to carry out effectively international commitments and the roadmap of international economic integration; to prepare and create internal conditions favourable to Vietnam becoming a WTO member.

- To renovate, fundamentally, the process of developing strategy, socio-economic development planning; to adjust significantly its economic structure.
- To continue effective implementation of poverty reduction and employment programmes.
- To renovate organizations and functions of the state; to invigorate administrative reform, to strengthen democracy and legislation enforcement; and to strengthen national solidarity.

References

CPV (Communist Party of Vietnam) (2004) *Materials of 9th Plenum of the Central Committee of the Communist Party of Vietnam* (Hanoi: National Political Publishing House), February (in Vietnamese).

Dapice, D. (2003) 'Vietnam's Economy: Success Story or Weird Dualism? A Swot Analysis', *Discussion Paper Series*, Department of Economics, Tufts University.

Kokko, A. (1999) 'Vietnam: Ready for *Doi moi* II', in Arndt, H.W. and Hill, H. (eds), *Southeast Asia's Economic Crisis: Origins, Lessons, and the Way Forward* (Singapore: Institute of Southeast Asian Studies).

Qian Y. (2001) 'How Reform Worked in China', Department of Economics Working Paper no. 473 (Berkeley, CA: Department of Economics, University of California).

Riedel, J. and Comer, B. (1997) 'Transition to Market Economy in Vietnam', in Woo, W.T.; Sachs, J. and Parker, S. (eds), *Economies in Transition: Comparing Asia and Eastern Europe* (Cambridge and London: MIT Press).

SRV (Socialist Republic of Vietnam) (2004) *The Comprehensive Poverty Reduction and Growth Strategy* (Hanoi: Government Office), November.

UNDP (various issues) *Human Development Report* (New York and Oxford: Oxford University Press).

Vo Tri Thanh (2000) 'Vietnam's Economy: The Weaknesses, Policy Responses and Obstacles to a Second Wave of Reforms', in Yuen, Ng Chee and Griffy-Brown, Charla (eds), *Trends and Issues in East Asia 2000*, IDRI/FASID, Tokyo.

Vo Tri Thanh and Pham Hoang Ha (2004) 'Vietnam's Recent Economic Reforms and Development: Achievements, Paradoxes and Challenges', in Taylor, Philip (ed.), *Social Inequality in Vietnam: Challenges to Reform* (Singapore: ISEAS).

World Bank (1996) *World Development Report – From Plan to Market* (Washington, DC: World Bank).

World Bank (2003) *Vietnam Development Report 2004: Poverty* (Hanoi: World Bank), December.

11

Vietnam's Road to International Economic Integration with a Socialist Orientation: Are WTO Accession and Market Socialism Compatible?*

Stephen Parker

An introduction to Vietnam's international economic integration in the context of its political commitment to market socialism

Professor Kornai has laid out a challenge for the chapters in this book to explore how the 'old' concept of 'market socialism' is applied to the 'new' experience in China and Vietnam. These are two Asian developing countries led by Communist Parties with legacies of 'old' socialist traditions (a command economy with dominant state ownership) that have achieved decades of rapid growth and major reductions in poverty by expanding the influence of markets, the private sector, foreign investors and international trade. Communist political leadership in these two countries, nevertheless, consistently represents their increasingly 'pragmatic' development strategies in the context of the more 'ideological' concept of developing 'a market economy with a socialist orientation'.

This chapter examines Vietnam's road to international economic integration with a socialist orientation over the last 20 years. In 1986, Vietnam introduced *doi moi*, or 'renovation', which consolidated and institutionalized politically a shift towards more pragmatic and market-friendly economic policies following a postwar decade of unsuccessful, command-based policies. Vietnam gradually liberalized and decentralized international trading and investment activities over the next 15 years, from a position as one of the poorest and most inward-looking economies in the world. The full impact of these reforms, however, was limited by the incomplete nature of the policy changes and insufficient institutional development, and by the lack of access to the US market, the traditional engine of growth for export-led economies in East Asia. As a legacy of the American (or Vietnam) War, conditions in Vietnam and the timing of reforms were a decade or more behind those of its Southeast Asian neighbours. The postwar US trade embargo was not lifted until 1994 and political relations were normalized in 1995.[1] Economic relations were normalized when the US–Vietnam Bilateral Trade Agreement (BTA) came into force on 10 December 2001 which, for the first time, effectively opened the US market for Vietnamese-based exporters. The BTA was designed by both countries to be a 'stepping-stone' towards WTO accession, which was achieved by Vietnam on 11 January 2007.

Economic reforms in Vietnam broadly, and efforts to integrate into global markets more specifically, accelerated around 2000. Systematic reforms were spurred on by a political recognition by the Communist Party of Vietnam (CPV) that rapid and sustained economic growth was required to create the millions of jobs needed to provide employment for the estimated 1.5 million new entrants into the labour force resulting from a postwar population boom, and to continue to reduce poverty in rural areas, where millions more hovered around poverty income levels. A keystone of political legitimacy for the CPV was the provision of social stability and rising prosperity. The positive lessons of China and other East Asian economies, and the perceived negative lessons of the European transition economies, made it clear to the CPV that sustaining major job creation, and thus sustaining political legitimacy, required a strong move to the market with market-oriented legal and administrative institutions, a growing private sector, and active integration into international markets.

Unlike Vietnam's neighbours several decades earlier, who internationalized their economies largely through unilateral trade reform with a dual strategy of promoting exports and targeted import-substitution sectors, the international political economy of trade reform in the 2000s had a much greater emphasis on using reciprocal trade agreements as a primary mode for trade and investment liberalization. These trade agreements were systematic in nature, including requirements for harmonizing domestic, legal and administrative structures with international practice alongside requirements to liberalize market access for goods, services and investment.

The three key trade agreements that began to drive economic and legal reform in Vietnam around 2000 were the implementation of the BTA, the application of substantial tariff reductions for goods to implement the ASEAN Free Trade Agreement (AFTA), and the serious preparation to meet the 'BTA Plus' requirements in order to accede to the WTO.[2] These trade agreements provided concrete and comprehensive benchmarks with specific deadlines for adjusting Vietnam's laws, regulations and administrative procedures to conform to international standards and best practice. In large part, these international requirements were consistent with even more systematic reforms aimed at modernizing Vietnam's legal system.[3] From roughly 2002 to 2006, most laws and regulations affecting commercial activity in Vietnam were rewritten to support a market economy and to conform more closely to international standards. Also, market access for most goods, services and investment were put on a course over the decade to be substantially liberalized.

The direction and pace of the reforms driven by implementation of these three trade agreements are clear – Vietnamese policy will be increasingly characterized by market forces, private and corporate economic organization, a more systematic and transparent rule-of-law with a stronger judicial system capable of resolving commercial disputes and protecting property rights, and increased international trade and investment. Conversely, the state will be increasingly less involved in directly administrating or controlling economic activity, and owning commercial enterprises.

How, then, does the systematic movement towards such a seemingly 'non-socialist' set of policies relate to market socialism? To explore this question, it is useful to examine how such strongly market-based international commitments are represented in domestic political terms. A number of recent Resolutions by the Communist Party of Vietnam put international integration and a socialist orientation into a broad development context. For example, Resolution 48 of the Politburo of the CPV on the 'Strategy for Development and Improvement of Vietnam's Legal System' issued on 24 May 2005 states as its objective, baseline considerations and directions:

> To develop and improve a . . . legal system with . . . legal regulations for a socialist-oriented market economy, to build a Vietnamese rule-of-law socialist state which is of the people, by the people and for the people . . . to accelerate the role and effectiveness of the law to contribute to good social management, maintaining social stability, developing the national economy, international integration, building a clean and strong state, implementing human rights and democratic rights and

> freedom of citizens, and to make Vietnam a modern, industrialized country by 2020.
>
> [Based on the] timely, full and accurate articulation of the Party's directions ... to actively integrate into the international community; to fully perform international commitments while strictly maintaining independence, state sovereignty, national defence and a socialist orientation ...
>
> To develop and improve the law on organizations and operation of institutions within the political system ... To renovate and continuously perfect the leading method of the Party, to ensure that operations of the Party are consistent with the Constitution and law; and to enhance the leading role of the Party over the State and Society.[4]

What is meant by socialist orientation in these Party Resolutions? For example, how might acceding to the market-oriented WTO differ if it is done with or without a socialist orientation? With regard to the tangible and extensive policy and institutional changes that are required for newly acceding countries to join the WTO, if anything, referral to a 'socialist orientation' raises questions about the commitment of an acceding country to conform fully to WTO standards and probably requires such a government to make stronger (more market-oriented) rather than weaker (less market-oriented) commitments in WTO accession negotiations. That the requirement in China's WTO Accession Protocol that its designation as a non-market-economy with regard to anti-dumping procedures in the USA and other countries can be maintained for 15 years after accession, for example, is partly a result of such suspicions. Even in the face of these concerns, however, Vietnam (and China) has maintained its political commitment to 'a modern market economy with a socialist orientation'.

One possible explanation commonly discussed is that socialist orientation with regard to markets and the rule of law represents a commitment that laws and policies reflect 'the will of the people' and that it be done 'under the leadership of the CPV'. It is not the actual policies and economic structure that have a socialist orientation, per se, but the outcomes and the political process for determining those policies that must be socialist oriented.

A common phrase representing CPV objectives is to strive to create a 'rich people, strong nation, and a civilized, democratic, equal society'.[5] In other words, political legitimization is derived to an important degree by providing social stability, basic personal and commercial rights under a rule of law, and broad-based, rising prosperity. Emphasis is placed on growth and modernization, but political objectives and concerns also include the distributional consequences of growth, a sense of social equity, and a commitment to the mass provision of social services. How these objectives can be achieved, and why the CPV has emphasized fundamental economic reforms such as those required for WTO accession, are strongly influenced by Vietnam's economic and demographic conditions.

Vietnam was a difficult country to characterize in the 1980s and 1990s. On the one hand, it was an extremely poor, agrarian country looking to jump into a high-growth, export-led development path in line with its East Asian Tiger neighbours. Many East Asian experts expected Vietnam to become the next Tiger. On the other hand, Vietnam was a transition economy shifting from an economy based on planning and state/collective ownership to one driven by markets, private ownership and international integration. Transition experts with a European background tended to look more cynically on Vietnam's minimal efforts to privatize its state-owned enterprises and the strong hand of the Party in guiding economic activity in Vietnam. Further, Vietnam was a newly unified country striving to develop its national integrity after decades of war and even more decades of colonialization. Important legacies from Cold War alliances and conflicts, reliance on Soviet subsidies, and the lack of normalized relations with the United States – and thus most western-oriented countries and multilateral donors – greatly, and somewhat uniquely, influenced Vietnam's policy decisions. Also, Vietnam is governed by a Communist Party that has cast a wide umbrella under which many interests vie. The CPV has increasingly tended to make 'pragmatic' development policy decisions under what is often termed a 'consensus' process among these broad interests. Each of these perceptions will be examined in greater detail, as follows.

First, Vietnam is a poor but solidly growing developing country just entering into its first stage of industrial development. To achieve the objective of becoming a modern, industrialized developed country by 2020, a huge amount of investment will need to be funded and allocated effectively over the next 12 years in order to build the social and physical infrastructure and to move into more sophisticated and (physical and human) capital-intensive industrial and service sectors that can accommodate the higher labour costs arising in a developed country. Although Vietnam's domestic savings rate has risen from around 18 per cent in 1995 to a quite respectable 27–28 per cent in the 2000s, foreign investment in terms of capital inflows and technical know-how will be critical.[6] Policies that create a good business environment with reliable property rights, predictable contracting procedures, and current account, exchange-rate convertibility, are essential to attracting such foreign investment. Creating a pro-investment environment that is familiar to investors by conforming to international standards, and legitimizing and binding these standards through international treaties, encourages foreigners to make the large, long-term investments that will be needed for Vietnam to achieve its development objectives.

Second, Vietnam is a transition economy. It started its market-based reforms in the mid-1980s with an economic structure based on a centrally planned system with predominant state ownership and bureaucratic control, resembling much more the former Soviet Union and Eastern European transition economies than Vietnam's Tiger neighbours. In this regard, almost all of Vietnam's leadership was educated in former socialist countries. Few Vietnamese, especially North Vietnamese, had any training in market economics and business, or had any exposure more broadly to either the West or, importantly, to reforming China and their economically dynamic East Asian neighbours.[7] On the other hand, because of Vietnam's quite low level of development in the 1980s, it had a much smaller and weaker state-owned sector, with moderate investment in heavier industries and, thus, relatively weaker political interests against the reforms.[8]

Third, Vietnam is facing the challenge of a postwar population bubble, where around half the population of 82 million people is under 25 years old. This translates into around 1.5 million young people entering into the labour force each year, coming in addition to tens of millions of largely rural people who tend to be underemployed and whose incomes hover around poverty levels. Under these conditions, to maintain social stability and to raise standards of living, millions of new jobs must be created each year. The lessons of other transition and developing economies, particularly Vietnam's successful East Asian neighbours, make it clear that generating large numbers of jobs in a country with a large and reasonably well-educated population requires policies that move to the market, expand the private sector, and integrate into global markets. In the eyes of many Vietnamese who were trained in the 'old' socialist systems of the former Soviet Union or Eastern Europe, the huge success of China's and other East Asian export-led development stands in stark contrast to the collapse of the Soviet/European transition economies.

Fourth, to expand labour-intensive exports rapidly, Vietnam needed access to world markets, particularly the US market, which has been traditionally the most receptive of the large developed markets for exports from developing countries. As a legacy of the war, even into the 1990s, Vietnam's export structure was skewed towards primary exports and towards trade with the former socialist countries. In this regard, Vietnam's export structure was quite different compared with its highly populated Asian neighbours. The year 1995 marked a watershed in Vietnam's move towards international integration. In that year, Vietnam joined ASEAN and committed to the accession protocols for membership in the ASEAN Free-Trade Agreement (AFTA), which aimed to lower tariffs reciprocally among Southeast Asian countries to 0–5 per cent over the next 10 years. Vietnam was required to reduce most of its tariffs on goods from ASEAN to 0–5 per cent by 2006. It also applied for WTO membership and started negotiations with the USA to normalize economic relations. These agreements did not bring about immediate changes in policy, but they did put in motion a comprehensive set of legal and economic reforms that would have to be implemented to fulfil the terms of these agreements, which would lead to major changes in Vietnam's policies from 2000 to 2005 and beyond. These reforms not only guaranteed Vietnam reliable market access to key foreign markets but, with their internationally bound commitments, they also cemented domestic reforms that would 'lock in' the role of the market, the private sector and international integration as the driving forces of economic activity in Communist-led Vietnam.

As will be explained in greater detail below, the impact of the BTA on Vietnamese exports was stunning. With the extension by the USA at the end of 2001 of normal trade relations (NTR), which is more commonly known as most favoured nation (MFN) treatment, USA tariffs on imports from Vietnam were reduced from an average of 40 per cent to an average of 4 per cent. Within just three years, Vietnam's exports to the USA surged by 500 per cent. By 2004, Vietnam exported more manufactured goods than primary goods, and the USA was Vietnam's largest export market. Vietnam's booming trade sectors (both exports and imports) began to look much more like those of its Tiger neighbours. US firms also became the largest investors in Vietnam in this year.

Fifth, and last, the state of Vietnam is Communist Party-led, which is a cornerstone of its conception of market socialism. As a one-Party state, however, it must cast a wide net over many economic, social and political interests. Changes in trade policy always create winners and losers, and requires some kind of political resolution for how the benefits and costs of reform are distributed and borne in society. Vietnam's Party-led political system is often characterized by having a 'consensus' driven process for making policy decisions and resolving conflicts among interests.[9] Much as in China, the strong growth and dramatic reduction in poverty achieved by Vietnam through the course of its 20 years of sustained development generated many more winners than losers. This has made the resolution of the distributional consequences of trade reform less onerous, and this economic success has generated considerable political legitimacy for the Party and for the reforms. Nevertheless, there has been considerable bureaucratic resistance from ministries and other state interests to reform state-owned enterprises, to streamline and make more transparent the administrative and licensing procedures, and to reform policies protecting certain sectors with strong state interests. Among many, there is still a lingering suspicion of private and foreign firms, and a belief that the state must guide economic activity to deliver socially beneficial results.[10]

The broad and deep reforms required of Vietnam to gain international market access under the global political economy of the 2000s, which is often considered to be a 'cost' or a concession in the parlance of trade negotiations, will considerably restrain Vietnam's and the CPV's flexibility to apply many of the typical economic and, particularly, industrial policies that its neighbours applied during their initial stages of industrialization and integration. Vietnam will have to industrialize and modernize with a greater reliance on competitive market forces and foreign investment than most of its Tiger neighbours or transition brethren had to in decades past. The challenge for the CPV is to understand and implement these systematic reforms, and then to articulate a political strategy to justify it within the Party's market socialist ideology. Also, it will be important to develop a political process for restraining predictably 'nationalistic' forces that will want a stronger role for state leadership in developing new capital- and knowledge-intensive sectors, in large infrastructure projects, and in the 'socialization' of the costs and benefits of the reforms. The Party's response to this challenge is typically cautious, gradualist, and step-by-step.

The next section examines in greater detail the actual policy changes underpinning Vietnam's integration into international markets, and their impact on trade and investment flows. The first 15 years of relatively gradual, but nevertheless quite substantive, trade and investment policy reform following the introduction of *doi moi* in 1986 are reviewed, followed by a focus on the acceleration of reforms from 2000 to 2006 as the impact of the trade agreements kicked in with full force. The subsequent section provides several conclusions as to whether WTO accession and market socialism are compatible.

Vietnam's economic integration process from 1986 to 2006[11]

From the late 1980s to around 2000, Vietnam steadily liberalized its trade and investment regime from a system largely inward looking and reliant on trade with European socialist economies to an outward looking system with exports to a wide range of economies, except for the United States. These initial reforms were conducted in large part along similar lines to its Southeast Asian neighbours. Most notably, the reforms were conducted unilaterally and thus were not bound by international agreement, and they applied a 'dual' strategy of protecting import-substitution sectors and promoting export sectors at the same time. Vietnam's international reforms in the 1980s and 1990s differed from those of their neighbours to some degree, however, because Vietnam started its reforms with a more dominant role for the state and state-owned enterprises in the trade process, a legacy of its planning and socialist heritage.

Before 1989, state-owned enterprises (SOEs) had a monopoly on international trade. In 1989, this monopoly was broken, but the ability of non-SOEs to engage in trade was severely restricted because export and import licences were required, and conditions for obtaining such licenses were onerous (including requiring a contract to export or import in advance, having minimum working capital, and having appropriate 'skills').[12] Since 1998, the licensing requirements for exporting and importing have been largely abolished. Although some restrictions on the products permitted to be traded remain, they are being progressively loosened. In 2001, all legal entities (companies and individuals) were permitted to export most goods without a licence.

Over this period, quantitative barriers to trade were reduced in the early 1990s, but then re-employed as a temporary measure to reduce demand on foreign exchange reserves in the wake of the Asian financial crisis (see Table 11.1). From 2000 to 2002, the use of quantitative restrictions diminished considerably. By the end of 2002, only two commodities, petroleum products and sugar, remained under quota, with sugar set to be removed from quota by the end of 2005. The almost complete removal of import quotas from 2000 to 2005 was agreed to by Vietnam as part of an IMF/World Bank loan programme and was in line with BTA and WTO requirements.[13]

The average tariff level in the 1990s was a relatively moderate 12–16 per cent level, and it has actually increased over time (see Table 11.2). Over this period, the tariff structure was repeatedly revised and many rates

Table 11.1 Products subject to quantitative restriction

1998	1999	2000	2001	2002
Petroleum	Petroleum	Petroleum	Petroleum	Petroleum
Sugar	Sugar	Sugar	Sugar	Sugar**
Fertilizer	Fertilizer	Steel	Steel	Cement*
Steel	Steel	Cement/clinker	Cement/clinker	Motorcycles*
Cement/clinker	Cement/clinker	Glass	Motorcycles	
Glass	Glass	Motorcycles	Cars	
Motorcycles	Motorcycles	Cars	Vegetable oil	
Cars	Cars	Paper		
Paper	Paper	Vegetable oil		
	Electric fans			
	Ceramic tiles			
	Porcelain			
	Caustic soda			
	Bicycles			
	Vegetable oil			
	Plastics			
	Plastic packaging			

Note: *Removed as of 31 December 2002; **sugar was scheduled to be removed in 2005, but this has not yet been done.
Sources: World Bank (2000); World Bank (2001); World Bank (2003a); IMF (2003). Implemented by the GVN as a Decision of the Prime Minister on managing exports and imports in the 2001–5 period, no.: 46/2001/QD-TTg, 4 April 2001.

Table 11.2 Applied nominal tariffs in Vietnam

	1995	1997	1998	2001	2003
Mean tariff rate	12.8	13.4	13.6	16.5	18.5
CV[a]	131	128	117	113	121
Number of bands	36	35	26	29	16

Note: Coefficient of variation = standard deviation/mean. The mean applied tariff rate is unweighted.
Source: Athukorala (2004).

increased to compensate for the loosening of the quota system following the Asian Crisis.[14]

As Table 11.3 indicates, the tariff schedule in Vietnam is one that cascades, with nominal tariffs in agriculture averaging only 6.2 per cent as compared to the average in manufacturing of 21.9 per cent in 1997. Consequently, the effective tariff rate in manufacturing (77.8 per cent)

Table 11.3 Nominal and effective tariff rates by sector in Vietnam, 1997, 2001 and 2003 (%)

	1997		2001		2003	
Vietnam	**Nominal tariff rate**	**Effective tariff rate**	**Nominal tariff rate**	**Effective tariff rate**	**Nominal tariff rate**	**Effective tariff rate**
Agriculture	8.1	7.7	6.3	7.4	12.7	14.7
Mining	9.4	6.1	8.9	16.4	3.6	0.03
Manufacturing	30.6	121.5	25.3	96.0	30.3	46.3
Overall average	21.0	72.2	17.9	58.5	19.6	27.1

Notes:
1 Tariff levels for these calculations are from the tariff schedule;
2 Sectoral averages of nominal rates are import weighted;
3 Sectoral averages of effective protection rates are weighted by value-added as reported in the Input-Output table for 2000.
Source: Athukorala (2004).

in 1997 was almost four times the nominal rate, suggesting a significant bias in favour of import-competing industries, typically dominated by SOEs.[15] During the early 2000s, however, the tariff structure was harmonized somewhat, primarily by increasing tariffs on intermediate inputs, rather than by reducing tariffs on final goods. As a result, the effective rate of protection declined to 27 per cent in 2003.

Pro-export policies have been used to offset the negative impact of import protection on exports. Most prominently, Vietnam introduced a scheme to rebate duties on imports of intermediate goods used in export production in 1991. In 1993, a duty suspension scheme was added that allowed exporters to suspend duty payments on imported inputs for 90 days. In 1998, the suspension period was extended to 275 days. In addition to suspension of import duties, exporters are exempted from value-added tax (VAT) and are given concessions on profit taxes, the amount of concession depending on the degree of export-orientation and location (for example, in rural areas or in industrial and export-processing zones).[16] Foreign-invested firms receive particularly generous tax incentives, typically including duty-free access for machinery and other capital goods imports. Finally, since the late 1980s, Vietnam has maintained a relatively pro-trade real exchange rate. Vietnam provides limited direct subsidies to exports. However, it does have special facilities to provide credit to exporters. Export taxes have been largely eliminated.[17]

Table 11.4 Export and import growth rates, shares in GDP and the trade deficit (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Export growth rate	34.4	33.2	26.6	1.9	23.3	25.5	3.8	11.2	20.6	31.5
Import growth rate	40.0	36.6	4.0	−0.8	1.1	30.8	2.3	19.4	27.9	26.5
Exports/GDP	26.3	29.4	34.3	34.5	40.2	45.6	46.2	47.6	51.0	58.5
Imports/GDP	39.3	45.2	43.3	42.4	40.5	48.5	49.9	56.3	63.9	70.5
Trade balance/GDP	−13.1	−15.8	−9.0	−7.9	−0.3	−2.8	−3.7	−8.7	−12.9	−12.0

Source: GSO and CIEM database.

In response to these reforms, international trade became the most dynamic component of the Vietnamese economy, as shown in Table 11.4. Except for two years of unusually low growth rates, Vietnam has increased the value of its exports by an average of 20–30 per cent a year.[18] In the larger context, Vietnam has grown its economy roughly by an average of 7 per cent a year over the 1990s and the first four years of the 2000s.

Until the opening up of the US market with the BTA, Vietnam's trade structure was skewed towards primary goods and away from manufactured goods, unlike their Asian neighbours who relied on a surge of manufacturing exports to fuel economic growth (see Table 11.5). Over the 1990s to 2002, the share of manufactures in total exports did not increase significantly, in spite of an acceleration of domestic manufacturing activity.[19] With the positive impact of the opening of the US market, manufactured exports have become relatively more important in 2003 and 2004. Within manufactured exports, the dominance of clothing and footwear attests to Vietnam's strong comparative advantage in these traditional labour-intensive products. It can be expected that Vietnam will diversify its exports into new labour-intensive products (electrical appliances, plastic products, toys and other miscellaneous products) that other developing countries, especially their Asian neighbours, exported in great abundance when they were at a stage of development comparable to Vietnam today.

Regarding foreign investment policy, as one of the first formal policies developed under *doi moi*, Vietnam promulgated its first Foreign Investment Law (FIL) in 1987, shortly after the Sixth Party Congress in December 1986 agreed to abandon central planning in favour of a 'market economy with a Socialist orientation'. Recognizing that Vietnam would have to compete with other countries in the region for foreign

Table 11.5 Commodity composition of exports and imports, 1995–2004 (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Exports										
Primary products										
Rice	9.5	11.7	9.5	10.9	8.9	4.6	4.1	4.4	2.6	3.6
Coffee	10.6	4.6	5.4	6.3	5.1	3.5	2.7	1.9	2.40	2.4
Fish/Seafood	8.3	8.9	8.6	9.2	8.4	10.2	12.3	12.2	11.0	9.0
Petroleum	19.7	18.3	15.6	13.2	18.1	24.2	21.9	19.5	18.6	21.4
Manufactured products										
Clothing	8.3	15.7	16.4	15.5	15.1	13.1	13.6	16.4	17.9	16.5
Footwear	3.8	7.2	10.7	11.0	12.0	10.1	10.8	11.1	11.2	10.2
Electronic products			4.8	5.3	5.1	5.4	4.2	3.1	4.2	4.1
Handicrafts	1.3	1.1	1.3	1.2	1.5	1.6	1.6	2.0	2.5	2.8
Furniture						2.0	2.2	2.6	2.8	4.3
Imports										
Machinery and equipment	25.7	27.6	30.3	30.5	30.1	30.9	30.4	29.8	32.4	27.0
Fuels and raw materials	59.1	60.0	59.6	61.0	63.5	63.8	61.6	62.3	61.2	68.0
Consumer goods	15.2	12.4	10.1	8.5	6.4	5.3	7.9	7.9	6.4	5.0

Source: GSO as provided by CIEM, GSO and MOT.

investment, the 1987 Law established a remarkably liberal regime for foreign direct investment in Vietnam.[20] The FIL governed a wide range of issues, including the forms of direct capital investment, procedures for licensing foreign investment, management of foreign-invested enterprises, capital contribution, personnel matters, taxation, accounting, foreign exchange and liquidation.[21] Foreign investment is permitted in most sectors, although it must be approved and licensed by the authorities. The FIL, early on, allowed 100 per cent foreign ownership, except for sectors where FDI is limited to joint ventures. Foreign investors in Vietnam receive a number of special incentives, such as customs duty exemptions in export processing zones and various tax exemptions. In addition, as in other countries in the region, the FIL provides an explicit pledge against expropriation or nationalization, and guarantees the right to repatriate capital and profits. Foreign investors were subjected to higher prices for certain services over the 1990s, but these forms of discrimination were eliminated by 2005 to meet BTA requirements. Reforms incorporated in the new Investment Law of 2005 further liberalized

Table 11.6 FDI and the capital account (US$ millions)

	1995	1996	1997	1998	1999	2000	2001
Capital account balance	2333	2105	1681	580	−337	−823	−576
Net FDI inflow	2276	1838	2074	800	700	800	900
Medium and long-term loans	−253	43	278	70	−423	77	−276
Short-term capital	311	224	−612	−290	−614	−1700	−1200
Capital account as percentage of GDP	11.2	8.4	6.2	0.8	−1.2	−2.5	1.8
FDI as percentage of capital account	97.9	88.1	124.8	370.4	−209.6	−103.6	156.2

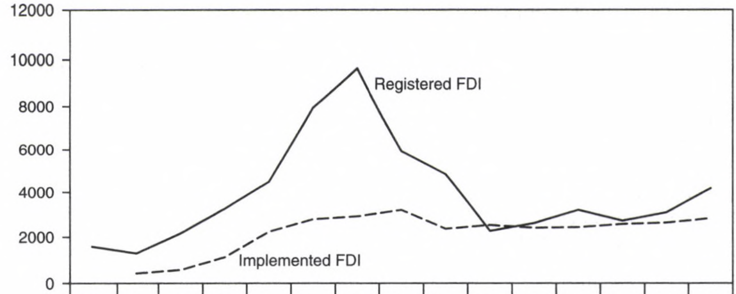
Source: World Bank (2003b).

investment registration procedures, including 'concessions' for opening investment in service and other sectors negotiated in the WTO Accession, and improving access to investment protection and arbitration procedures.

In the mid-1990s, in line with major FDI inflows throughout the region, capital inflows to Vietnam surged to a level equivalent to 11.2 per cent of GDP in 1995, mostly in the form of FDI. With the onset of the Asian financial crisis, however, foreign capital of all kinds dried up. Simultaneously, while capital inflows fell, Vietnam still had to repay short-term foreign loans and the longer-term loans of foreign investors. Thus, by 2000, Vietnam generated a net capital outflow equivalent to 2.5 per cent of GDP (see Table 11.6). This trend has been reversed in the 2000s, as capital inflows have grown rapidly.

Although registered FDI into Vietnam spiked strongly in the mid-1990s, in fact, many of these FDI projects were never implemented (see Figure 11.1) as the Asian crisis hit. After a downturn in 1998 at the height of the crisis, however, implemented FDI into Vietnam has grown moderately but steadily.

Table 11.7 shows the sector composition of FDI flows to Vietnam since 1995. Several notable trends are worth mentioning. First and foremost is the relatively low, albeit rising, share of FDI in light, labour-intensive manufacturing. Most industrial FDI is in heavy industry, which is a capital-intensive activity, as are the other main areas of FDI – oil, construction, transportation and communication, and real estate. Consequently, while FDI accounts for a significant share of GDP (13.3 per cent), industrial production (35.5 per cent) and domestic



	88–90	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Registered FDI	1582	1291	2161	3262	4499	7950	9635	5955	4873	2282	2629	3226	2739	3112	4222
Implemented FDI		428	575	1118	2241	2792	2923	3218	2375	2537	2420	2450	2591	2650	2850

Figure 11.1 Overall registered and implemented FDI from all countries (US$ millions)
Note: The FDI data in this figure are not adjusted for dissolved and expired projects.
Source: Vietnam Ministry of Planning and Investment.

investment (18.5 per cent), it accounts for only a miniscule share of employment (about 400,000 jobs out of a work force of 40 million).[22]

A second notable trend in FDI is its growing export orientation. Between 1995 and 2000, the share of FDI in manufactured exports increased from 8.8 per cent to 33.8 per cent, and this trend is generally regarded to have continued over the 2000s.[23] Official statistics show that most FDI from Vietnam comes from East Asian countries, investing increasingly in labour-intensive manufacturing for export. As noted below, however, FDI from overseas subsidiaries of US firms has been much larger than realized. Overall, nevertheless, FDI has been a major source for expanding Vietnamese exports over the last 15 years, and that importance is expected to continue well into the future.

The Impact of the BTA on Vietnam's trade and investment

The BTA, which normalized economic relations between Vietnam and the USA, was built upon a prototype established by NAFTA in the sense that it covered a wide range of policies, laws and administrative procedures that go far beyond traditional tariffs and non-tariff barriers to trade. Furthermore, a key strategic element of the BTA for both countries was that it would be a 'stepping-stone' for accession to the World Trade Organization, a process that Vietnam started in 1995 along with the BTA negotiations with the expectation that Vietnam would accede

Table 11.7 Sector composition of FDI disbursements

	1995	1996	1997	1998	1999	2000
Total FDI disbursements (US$ millions)	2341	2491	2878	2246	2041	1959
Total IMF estimates (US$ millions)	2276	1831	2074	800	700	800
Total FDI flows as % of GDP	11.3	10.1	10.7	8.3	7.2	6.5
IMF total as % of GDP	11.0	7.4	7.7	3.0	2.5	2.7
Flows in US$ millions						
Industry	801	1141	1326	922	835	910
Heavy industry	314	478	701	491	424	445
Export processing	34	136	88	43	49	14
Light industry	267	412	363	225	182	326
Food	186	116	174	164	178	126
Oil and gas	576	377	261	375	345	205
Construction	133	261	407	198	152	221
Transport & communications	155	82	101	80	106	28
Real estate	433	421	488	471	340	299
Ag., forestry & fisheries	130	113	234	124	192	208
Services	120	95	61	77	71	87
Flows as % of total disbursements						
Industry	34.2	45.8	46.1	41.1	40.9	46.5
Heavy industry	13.4	19.2	24.4	21.9	20.8	22.7
Export processing	1.5	5.5	3.1	1.9	2.4	0.7
Light industry	11.4	16.5	12.6	10.0	8.9	16.6
Food	7.9	4.7	6.0	7.3	8.7	6.4
Oil and gas	24.6	15.1	9.1	16.7	16.9	10.5
Construction	5.7	10.5	14.1	8.8	7.4	11.3
Transport and communications	6.6	3.3	3.5	3.6	5.2	1.4
Real estate	18.5	16.9	17.0	21.0	16.7	15.3
Ag., forestry & fisheries	5.6	4.5	8.1	5.5	9.4	10.6
Services	5.1	3.8	2.1	3.4	3.5	4.4
Total disbursements	100.0	100.0	100.0	100.0	100.0	100.0

Note: Total FDI disbursements are collected according to Vietnamese government definitions.
Source: IMF (2003).

to the WTO while BTA implementation was taking place, which in fact happened as planned.

The BTA, made up of more than 100 pages of text and tables organized in seven chapters, included an extensive set of obligations on trade in goods and services, protection of intellectual property rights, liberalization and protection of foreign investment, trade facilitation, and transparency and the right to appeal. Interspersed throughout the BTA were requirements for developing modern and effective dispute settlement procedures in line with international standards that, in particular, required strengthening of the Vietnamese judicial system. A major difference between the BTA and NAFTA was that it required that Vietnam reduce tariff levels by around one third for only 261 out of more than 10,000 tariff lines.

The BTA had two profound effects. First – and most importantly, in terms of short-term economic impact – the BTA required that the USA extend most favoured nations (MFN) or normal trade relations (NTR) status to Vietnam. On the day that the BTA came into force, 10 December 2001, the USA lowered tariffs from its general tariff schedule, which averaged around 40 per cent per tariff line, to the MFN levels, which averaged around 4 per cent. This opened the US market fully for Vietnamese exports. On the part of the Vietnamese, the BTA provided a clear roadmap of reforms to legal and administrative practices that would bring them more into conformance with their trade and investment partners, and which would be required for WTO accession. In addition, it started the process of liberalizing access to a number of service sectors, allowing a phasing in of competition from US firms in the lead up to full liberalization of services in the WTO accession process.[24]

The trade and investment impact of the BTA on Vietnam has been stunning. When the BTA came into force, there was considerable 'export pessimism' that fledgling Vietnamese businesses, in large part state-owned, would not be able to compete and export to the US market. In fact, Vietnam increased its exports to the USA by 450 per cent over the first two years of the BTA, which in fact accounted for a substantial amount of the overall growth in Vietnamese exports over 2002 and 2003 (see Table 11.8). This export surge had a major influence on the political economic dynamic of reforms in Vietnam. Clear and rapid success was seen widely – Vietnamese firms could export to the USA, and many new jobs were created.[25]

The foreign investment response following implementation of the BTA by US firms has been almost as dramatic. This response, however, was harder to see from regularly reported FDI, which measures bilateral capital flows from the USA to Vietnam. In fact, most US-related FDI into Vietnam is done through overseas subsidiaries of US multinational firms. If FDI from overseas US firms is added to regularly reported FDI sourced directly from the USA, a strong surge in 'US-related' FDI occurred following the implementation of the BTA (see Figure 11.2).[26]

Table 11.8 Value and growth rate of Vietnam's exports to the USA by commodity category, 2002–June 2005

	2002 Value ($ '000)	2002 Growth (%)	2003 Value ($ '000)	2003 Growth (%)	2004 Value ($'000)	2004 Growth (%)	Jan–Jun 2005 Value ($'000)	Jan–Jun 2005 Growth* (%)
VN Exports to USA	**2,394,745**	**128**	**4,554,860**	**90**	**5,275,810**	**16**	**2,938,010**	**23**
Primary Products	**994,286**	**21**	**1,274,979**	**28**	**1,309,771**	**3**	726,113	17
Fish and seafood	616,028	29	732,135	19	568,466	−22	252,856	−17
Vegetables and fruit	76,000	52	106,001	39	183,615	73	83,835	31
Coffee	53,061	−30	76,301	44	113,677	49	79,173	18
Crude rubber	11,232	300	13,282	18	17,187	29	9,255	40
Petroleum	181,125	−1	277,565	53	349,126	26	264,429	91
Other primary	56,840	92	69,695	23	77,700	11	36,565	2
Manufactures	**1,400,461**	**502**	**3,290,930**	**135**	**3,966,042**	**21**	**2,211,898**	**25**
NM mineral products	19,590	115	27,939	43	32,138	15	23,582	27
Metal manufactures	8,381	137	15,559	86	31,145	100	22,823	97
Electrical appliances	4,950	270	4,141	−16	3,023	−27	2,935	160
Furniture	80,441	499	187,774	133	386,289	106	317,711	125
Travel goods	49,535	5,422	85,955	74	109,847	28	62,075	17
Clothing	900,473	1,769	2,380,249	164	2,571,119	8	1,186,718	2
Footwear	224,824	70	327,300	46	475,116	45	354,355	49
Misc. manufactures	28,238	847	48,541	72	92,227	90	70,598	80
Other goods	84,029	297	213,472	154	265,138	24	171,101	60
NC Manufactures**	**499,988**	**162**	**910,681**	**82**	**1,394,923**	**53**	**1,025,180**	**68**
NCF Manufactures***	**275,164**	**424**	**583,381**	**112**	**919,807**	**58**	**670,825**	**81**

Notes:
*The first six months of 2005 as a percentage of the first six months of 2004.
**Manufactures less clothing.
***Manufactures less clothing and footwear.
Source: US International Trade Commission website (www.usitc.gov). Imports from Vietnam into the US are valued 'cif', which includes the cost of insurance and freight to ship products from Vietnam to the port of entry into the United States.

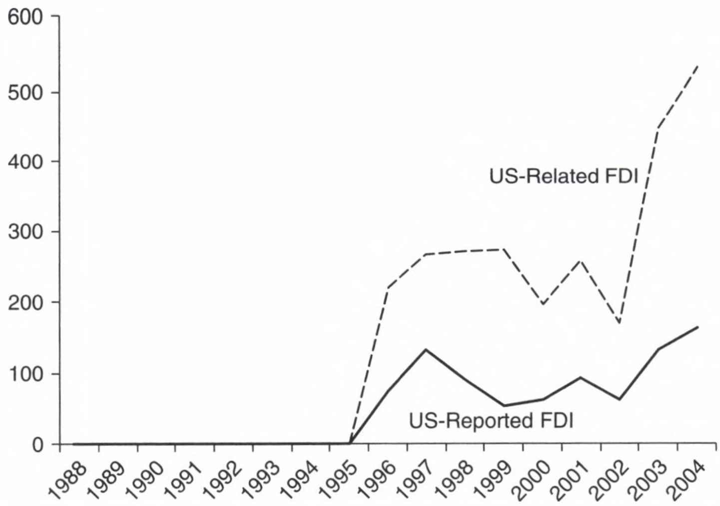


Figure 11.2 Implemented US FDI in Vietnam (US$ millions)
Note: The FDI data in this figure are not adjusted for dissolved and expired projects.
Source: Vietnam Ministry of Planning and Investment.

Conclusion

The central question of this chapter has been whether the market-oriented reforms required for accession to the WTO are compatible with Vietnam's political commitment to market socialism. The answer for Vietnam appears to be 'yes' – at least, for the foreseeable future. We posit that the central political element of 'a market economy with a socialist orientation' in Vietnam is the fulfilment of the 'objectives perceived to be expressed by the people' under the ongoing leadership of Communist Party of Vietnam. Starting as one of the poorest countries in the world in the mid-1980s, the market reforms associated with Vietnam's increasing integration into global markets – accelerated over the last five years in particular through the negotiation and implementation of trade agreements such as the WTO – have generated strong, sustained and broad-based growth with substantial reductions in poverty. Daily life for the vast majority of Vietnamese has improved considerably over the last 20 years.

This provides considerable political legitimacy to the current system, but it also requires that the pragmatic realities of these policy reforms be incorporated into Party ideology. At least for the foreseeable future, the maintenance of economic reform in the context of market socialism appears to provide an ideological umbrella that satisfies the internal needs of the CPV. It maintains a link with the past and the justification for CPV political leadership, and it embeds a respect for social justice. At the same time, it allows ever-more rapid reforms that move Vietnam's economy further and further away from the reality of a 'socialist' economy, generating rapid growth and further reductions in poverty, but also increasing the gap between rich and poor over time, even as the poor become better off.

As seen in China, rapid growth and development raise new economic, social and political challenges. It is beyond the capacity of this chapter to hypothesize how these systems will evolve over time. To date, there is no historical experience as to how rapidly growing, market-oriented, developing countries under Communist Party leadership will adjust as they become increasingly developed and integrated into the global community.

Notes

* This chapter reflects my personal views only and does not necessarily represent the views of either the US or Vietnamese governments. I would like to thank James Riedel and Phan Vinh Quang for their substantial contribution to developing the STAR-Vietnam reports on the economic impact of the BTA, from which much of the trade analysis used in this chapter is derived.

1. Key official relationships with the multilateral financial/development institutions and many bilateral donors were not advanced until around this time as well.
2. Vietnam was accepted into the WTO in November 2006, with the formal entry date 10 January 2007. Also, in 2003 and 2004, two additional bilateral agreements were negotiated, one a textiles and services agreement with the European Union and the other an investment agreement with Japan. In both cases, Vietnam received some benefits for essentially providing BTA treatment to European banks and other service providers, and to Japanese investors.
3. Although this chapter focuses on Vietnam's international integration, it is important to note that accession to these 'strong' trade agreements was part of an even more systematic effort to reform Vietnam's domestic economy and to modernize its institutional, administrative and legal systems. For example, typically for the more than 70 laws and regulations that were developed or amended from 2002 to 2006 to implement the BTA and to accede to the WTO, most of the new language was directed at domestic activity rather than meeting international requirements. Over this period, Vietnam largely 'filled out' and deepened its legal system for commercial activity and judicial procedures, which is why so many entirely new or

strongly revised laws were developed over this period. If the object had only been to meet international commitments, much less adjustment would have been required in Vietnam's legal system. But, clearly, changes made only to meet international requirements would have been much less effectively implemented if parallel and supportive reforms were not made to the full domestic legal structure in order to operate a robust market economy with a growing private sector. For example, Vietnam fully reformed its laws on contracts, domestic company registration, negotiable financial instruments, electronic commerce, and secured transactions; all fundamental elements of a market economy, but none of which faced specific requirements in the trade agreements. As would be expected, compared with the reinforcement between domestic and international pressures to modernize legal and administrative procedures, there is more conflict between domestic interests and treaty requirements regarding liberalizing market access in various sensitive sectors.

4. Central Committee of the Communist Party of Vietnam, Number: 48-NQ/TW, Hanoi, 24 May.
5. Duong Thi Thanh Mai, 10–11 October 2005.
6. The role of foreign investment in Vietnam is particularly important because of the structure and maturity of Vietnam's private sector. Vietnam has almost no large private firms, and relatively few private firms are in the manufacturing sector. This is partly a legacy of the socialist system and Vietnam's low level of development, and partly due to the small size of Vietnam's ethnic-Chinese community, a group that provided access to capital and marketing/production networks when Vietnam's neighbours in Southeast Asia (and China) liberalized. This creates a political dilemma for Vietnamese leadership. Until capital markets and other institutions facilitate the development of larger private firms, the only organizations with the size and substance to make major investments are state-owned firms and foreign firms, both of which pose certain problems. Channelling large investments through SOEs raises concerns about efficiency, and dominance by foreign firms in key 'national' sectors raises concerns about sovereignty and equity.
7. Relations between Vietnam and China soured considerably after the short 1979 war, and few Vietnamese travelled to China until well into the 1990s. This represents an important difference with the wide exposure of leaders in other East Asian countries when they began to reform. These countries often had literally hundreds of PhD economists from the USA and Europe, as represented by the famous 'Berkeley Technocrats' who were so influential in Indonesian reforms from the mid-1960s until the 1990s. Although China also had few Western-trained officials when it came out of the Cultural Revolution and began to reform in the early 1980s, China did have ready access to strong ethnic-Chinese business and intellectual connections through Hong Kong, Taiwan and the global ethnic-Chinese diaspora. Many of Vietnam's ethnic Chinese had left Vietnam by the early 1980s, often as 'boat people'. In this regard, the lack of connections to the wealthy and well-connected ethnic-Chinese business networks limited Vietnam's access to the capital and market connections from which most other Southeast Asian countries benefited when they liberalized.

8. The articles in Woo, Parker and Sachs (1997), and Sachs and Woo (1994), examine similarities and differences between the transition experiences of Asian and European countries. In particular, they note the importance of differences in initial economic structure. The European transition economies started from a much higher level of development, with resources heavily industrialized and highly misallocated. In retrospect, the substantial reductions in output that occurred in the transition from a planned to a market-driven economy seem predictable. The Asian transition economies, particularly Vietnam, started from a much poorer and less developed position, where the move to the market could mobilize quickly excess labour in agriculture; first to stimulate agricultural production, and then labour-intensive manufacturing. The transition in Asia represented a shift to a new development strategy (with transition characteristics) that was more market and outwards-oriented, and which generated strong, relatively broad-based growth. The change in development strategy in the Asian transition economies, and the positive economic results of these reforms, resembled much more the shift toward an export-led growth strategy by Vietnam's East Asian 'developing' neighbours than Vietnam's European 'transition' brethren.
9. There is an extensive consultation process for the drafting and approval of most laws and regulations, starting with inter-ministerial government drafting teams, then followed by comments and review by agencies within the government, the Prime Minister, and then by the increasingly powerful National Assembly and by the Party. And, increasingly, draft laws and regulations are being released for public comment, and for comment on by foreign businesses, governments and donor technical assistance programmes. Although the decision process to approve and implement laws and regulations is intensely domestic, with Vietnam entering into more and more international agreements, international standards, best practice and treaty requirements are increasingly a prominent consideration for most law-making in Vietnam. This consultation process tends to produce a relatively gradual but steady set of reforms, giving time to work out compromises as needed among interest groups.
10. These suspicions, of course, are not a monopoly of a Communist Party. In the reform efforts throughout East Asia – and, in fact, in most countries – there is a 'nationalist' or 'populist' political force that often resists reforms and change, especially if such change is seen as affecting their 'status quo' interests. Bureaucratic resistance to change that might reduce 'power' and rent-seeking opportunities is common. More broadly, an axiom of trade policy reform is that the winners tend to be broad and diffuse, with benefits occurring often well into the future, while costs are focused and current.
11. For a more detailed analysis of the evolving structure of Vietnam's trade policy structure, see Athukorala (2004). Much of this section is drawn from the Center Institute for Economic Management and STAR-Vietnam Reports on the economic impact of the BTA on Vietnam (June 2003; December 2003; and June 2004).
12. The trade reforms were part of a much more comprehensive set of fiscal and monetary policy adjustments to deal with the quite high inflation that resulted from freeing up prices and unifying the exchange rate as part of the

doi moi process. The collapse of the Soviet Union and the abrupt withdrawal of substantial Soviet budgetary support for Vietnam in 1989 and 1990 further heightened the pressure for reform.

13. The IMF/WB commitment was contingent for the five-year period of the loan, but the BTA and WTO commitments not to use import quotas are bound permanently.
14. Athukorala, P. (2002) 'Trade Policy Reforms, Export Strategies and the Incentive Structure in Vietnam,' draft, March, p. 3.
15. It is important to note that smuggling of many goods into Vietnam, particularly from China, has been endemic. In practice, Vietnamese firms often must compete directly with smuggled goods, creating a quite tough competitive environment and diminishing the actual impact of protective policies.
16. Athukorala (2004) estimates an anti-export bias, indicating that a full duty rebate on imported inputs and additional pro-export policies would reduce the average anti-export structure of tariff protection considerably, but not completely.
17. One constraint on exports not related to the trade policy regime is the insufficient availability and high cost of infrastructure services. Limitations in Vietnamese ports, transportation, power and telecommunication sectors, and lagging reforms in education, cause basic operating and logistical expenses to be higher in many cases than neighbouring competitors. Le Duc Tan (2002): p. 29.
18. The collapse of export growth in 1998 is widely attributed to the Asian financial crisis, since Asian countries are an important destination of Vietnam's exports. However, the compression of imports, which began in 1997, no doubt contributed to the decline in export growth in 1998, since about 40 per cent of inputs in industrial production are imported. The decline in export growth in 2001 is also attributable to the slowdown in the world economy and its deleterious effect on the prices of Vietnam's key primary commodity exports – rice, coffee and petroleum.
19. Vietnamese trade data do not allow aggregation of exports and imports into the traditional analytical aggregates of primary products and manufactures. Of total merchandise exports over the 1990s, rough estimates indicate that primary exports accounted for about 60 per cent and manufactured exports for about 40 per cent. These proportions reversed, roughly, in the 2000s.
20. Alan Gutterman (1997).
21. Pham Duy Nghia (2002): 266.
22. Prema-Chandra Athukorala (2002).
23. *Ibid.*
24. A number of important complementary reforms were initiated over recent years that were aimed at improving the governance and institutional environment for the development of the private sector and a market economy. Possibly most dramatically, the Enterprise Law in 2000 streamlined the registration procedures for private firms, which has subsequently resulted in the establishment of more than 150,000 new private firms. Also, the government unified its court system under one institution, the Supreme People's Court, and passed new and much more modern civil and criminal procedure codes. It is working on developing a new Judgement Enforcement Code to improve

the enforcement of court decisions, and the courts are beginning to publish some court decisions for the first time. The government has implemented a major public administration reform programme and a new Land Law, and has developing a new Anti-Corruption Law. A stock market was established in 2000. Many of these reforms reflect the guidelines announced at the IX Party Congress in 2000. Nevertheless, even with the many legal reforms completed in Vietnam since 2000, there is still a major challenge to be met in order to implement these reforms effectively in practice.

25. Initial analysis shows that little of this growth in exports to the USA resulted from 'crowding out' exports to other countries (see CIEM database and STAR, 2003 and 2004).
26. See FIA and STAR (2005) for a more detailed analysis of the impact of the BTA on FDI into Vietnam. Singapore is the most common base of FDI from US MNCs to Vietnam, which would be reported in normal FDI statistics as FDI from Singapore.

References

Athukorala, Prema-Chandra (2002) 'Foreign Direct Investment and Manufacturing Exports: Opportunities and Strategies' (Washington, DC: World Bank).

Athukorala, Prema-Chandra (2004) 'Trade Policy Reforms and the Structure of Protection in Vietnam' (Hanoi: Ministry of Finance of Vietnam and the Asian Development Bank, Finance Publishing House), April 2004.

Central Committee of the Communist Party of Vietnam, Number: 48-NQ/TW, Hanoi, 24 May 2005, 'Resolution of the Politburo of the Communist Party of Vietnam on Strategy for Development and Improvement of Vietnam's Legal System to the Year 2010, and Directions for the Period up to 2020', released at the Biannual Conference and Legal Partnership Forum sponsored by the UNDP, SIDA (the Swedish Development Agency) and DANIDA (the Danish Development Agency), Danang, 10 October 2005.

Central Institute for Economic Management and STAR–Vietnam (2003) 'An Assessment of the Economic Impact of the United States–Vietnam Bilateral Trade Agreement: Annual Economic Report for 2002' (Hanoi: National Publishing House), June.

Central Institute for Economic Management and STAR–Vietnam (2003) 'An Assessment of the Economic Impact of the United States–Vietnam Bilateral Trade Agreement: Economic Report for the First Six Months of 2003' (Hanoi: National Publishing House), December.

Central Institute for Economic Management and STAR–Vietnam (2004) 'An Assessment of the Economic Impact of the United States–Vietnam Bilateral Trade Agreement: Trade Update Report for 2003', National Publishing House, June.

'Decision of the Prime Minister on Managing Exports and Imports in the 2001–2005 Period' (2001) no.: 46/2001/QD-TTg, 4 April.

Duong Thi Thanh Mai (2005) 'Key Issues of the Strategy for Development and Improvement of Vietnam's Legal System to the Year 2010 and Directions for the Period up to 2020,' Biannual Conference and Legal Partnership Forum, Danang, 10–11 October.

Foreign Investment Agency of Vietnam and STAR–Vietnam Project (2005) 'The Impact of the US–Vietnam Bilateral Trade Agreement on Overall and US Foreign Direct Investment in Vietnam' (Hanoi: National Publishing House), November.

Gutterman, Alan (ed.) (1997) *Commercial Laws of East Asia* (Hong Kong: Sweet & Maxwell Asia).

IMF (2003) 'Vietnam: Selected Issues and Statistical Appendix, 2002' (Washington, DC: IMF).

Le Duc Tan (2002) 'Tall Order', *Vietnam Economic Times*, June.

Parker, Steve; Phan Vinh Quang and Nguyen Ngoc Anh (2005) 'Has the US–Vietnam Bilateral Trade Agreement Led to Higher FDI into Vietnam?', *International Journal of Applied Economics*, Special Edition, 2(2), September. Available at www.selu.edu/orgs/ijae

Pham Duy Nghia (2002) *Vietnam Business Law in Transition* (Hanoi).

Sachs, J., and Woo, W.T. (1994) 'Structural Factors in the Economic Reforms of China, Eastern Europe and the Former Soviet Union', *Economic Policy*, April.

US International Trade Commission website, at www.usitc.gov

Woo, Wing Thye; Parker, Stephen and Sachs, Jeffrey D. (eds) (1997) *Economics in Transition: Comparing Asia and Europe* (Cambridge: MIT Press).

World Bank (2003a) *Vietnam: Delivering on its Promises* (Hanoi: World Bank).

World Bank (2003b) *Vietnam Development Report, 2003* (Hanoi: World Bank).

World Bank (2001) *Vietnam Economic Monitor, 2001* (Hanoi: World Bank).

World Bank (2000) *Vietnam: Entering the 21st Century, 2000* (Hanoi: World Bank).

12
Market Socialism in China and Vietnam: Why has it Worked, so Far?

David Daokui Li and Yijiang Wang

Introduction

Students of the former socialist systems have long concluded that such systems consisting of tight political control and non-market coordination mechanisms were internally coherent. By implication, any effort to reform the economic system without a drastic political change is doomed to fail. The history of economic reforms in Eastern Europe has largely confirmed this view. However, the reform experiences of China and Vietnam have defied this logic and thus represented a puzzle. This chapter tries to resolve this puzzle on the political strengths and control efficiency of the Communist parties in China and Vietnam based on their long history of military campaign, strong nationalist appeal, and strong support from a less educated and poorer population. With the help of a model, we show that, due to these differences in initial political conditions, the Communist parties in China and Vietnam are more likely to devolve partial power to implement an effective economic reform.

China versus Eastern Europe – or, more precisely, China and Vietnam versus Eastern Europe and the former Soviet Union – in their different approaches to reform, have always been a focal point of attention in academic and policy communities. Indeed, the two groups of economies represent two contrasting cases. China and Vietnam have not implemented – or, have successfully resisted – drastic political reform but have carried out extensive and, by most standards, very successful market-oriented reforms. Meanwhile, since the early 1990s most of the Eastern European countries and the former Soviet Union have gone through drastic political change followed by transition to a market economic system.

In this chapter, we are not interested in the question of which one of these two groups of countries has implemented the right or wrong strategies of reform or transition, although we are aware of the large literature debating this issue. For example, some people argue that China and Vietnam will eventually run into serious barriers to further economic reform due to the lack of political reform (Sachs, Woo, and Yang, 1999). We are not interested in such normative topics and predictions of the future. Instead, we are interested in the positive question as to why the two groups of countries have chosen different strategies of reform and transition.

Besides its obvious policy significance, our study is also motivated by the observation that China and Vietnam have, for the past 20 years, presented a puzzle to the students of the former socialist economies, János Kornai (1992) being one of the most articulate scholars among them. These students concluded from their studies that, in the former socialist countries, the political and economic systems are coherent, consistent and intertwined with each other. By direct implication, any market-oriented reform without fundamental political change is doomed to failure. The experience of the market-oriented reforms in Eastern European countries and the former Soviet Union before the collapse of their political systems in the early 1990s confirms this view. However, the experiences of China and Vietnam have long defied this logic. In the past few decades, these two countries did not experience any drastic political change. The same ruling parties remain in power without any significant challenge. At the same time, extensive economic reforms have been implemented, which, by most standards, have been successful.

To resolve the puzzle of the Chinese and Vietnamese reform experience, we observe a simple and very important fact: the initial political conditions in China and Vietnam are fundamentally different from those in Eastern Europe and the former Soviet Union. The difference lies in two related dimensions. The first is the degree of political stability. Due to the history of long and brutal military action, the Communist parties in China and Vietnam enjoy a level of political and military control that is far above the threshold level necessary to maintain national power. In Eastern Europe, with the former Soviet Union providing critical political and military support to the regimes, this was not the case. The second related dimension is in the level of efficiency of political control. In China and Vietnam, thanks to thousands of years of a feudalistic socio-political system and to the fact of a lower level of education and accumulated wealth among the population, the ruling parties are much more efficient in implementing political control, in the sense that the marginal cost of political control is lower in China and Vietnam than in Eastern European and the former Soviet Union.

These two fundamental differences in initial political conditions suggest that, in China and Vietnam, a drastic political change is not likely to happen, since the population's desire for such a change is low due to the low economic cost of political control. At the same time, the resistance from the ruling party to such a change is high due to their solid position of control. With strong control in place, the ruling party can afford to loosen political control moderately without worrying about losing power completely. This is the political logic behind the Chinese and Vietnamese economic reforms.

Our analysis complements that of the students of former socialist systems in that, while they have focused on certain special cases of socialist systems where the ruling party is relatively weak and economically inefficient in maintaining political control, we add to the picture the cases of China and Vietnam, where the ruling parties are strong and efficient in maintaining political control. In their cases, a moderate extent of economic reform does run into political barriers and threaten continued political control by the ruling party. Indeed, in such cases, economic reform without drastic political reform is impossible. In the cases of China and Vietnam, substantial reform measures can be introduced without threatening the ruling party's political control.

There are two existing theories relating to China compared to Eastern Europe, to which our theory is partially related, although neither theory directly addresses the puzzle to which we have drawn attention. The first is by Sachs and Woo (1992) on differences in initial economic conditions. They argue that, at the beginning of economic reform, China and Vietnam were not only much more agricultural, but also had less penetration of central planning and state ownership than Eastern Europe and the former Soviet Union. These differences made China and Vietnam's approaches to economic reform feasible and duplicating their approach in the other group of economies impossible. The second theory is by Qian, Roland and Xu (1999), who observe that China had a much more decentralized economy with over 30 provinces, each behaving like a subsidiary of a multidivisional corporation. Meanwhile, the Eastern European countries and the Soviet Union were organized more like U-formed corporations with intense regional specialization. It is easier to implement economic reform in China than in the other group of countries, according to their analysis.

The chapter is organized as follows. The next section reviews Kornai's theory of the socialist system, and is followed by a section that explains the differences in initial political conditions between China and Vietnam, and Eastern Europe and the former Soviet Union before the transition. The subsequent section uses a simple model to explain the implications of the differences in the initial political conditions. The chapter goes on to relate the predictions of the model to the reality of reform experience and concludes with a summary.

Three affinities in the socialist system

In his long career, studying the former socialist systems and their transition to a market economy, János Kornai systemically analysed the inner logic and coherence of the former socialist systems. In his seminal work *The Socialist System* (Kornai, 1992), Kornai observes many features of the socialist system that are different from those of a market economy. However, these features are internally coherent with each other, with the more fundamental features causing the others, directly or indirectly. The most important insight that emerged from his analysis is summarized in the concept of three affinities in socialism (see Kornai, 1992: ch. 6). By direct implication, any reform that only changes a sub-set of the institutional arrangements is doomed to fail in changing the behaviour and performance of the economy; that is, reform short of completely overturning the political economy of the socialist system is destined to failure.

Affinity 1

The first affinity is between the undivided power of a Marxist–Leninist ruling party and the predominance of state ownership. The argument for this affinity is that the ruling party needs to maintain strong control of the economy in order to consolidate its political control. Also, the official ideology of the ruling party advocates the superiority of state ownership. Both factors lead to the dominance of state property, which is implemented in different ways.

Affinity 2

The second affinity is between the predominance of state ownership of property and bureaucratic coordination. Kornai argues that the predominance of state ownership leads to a natural tendency for government officials who are in control of state assets to use direct administrative means, rather than market instruments, to settle economic affairs. More fundamentally, he explains that the 'owner' of state properties is government officials, who are organized in a hierarchical structure, rather than horizontally. Market coordination is based on horizontal relationships, where market participants are equals and can act upon their free will. It is therefore impossible for those hierarchically structured government officials to act as peers in a marketplace, even though often various reform measures call for them to do so. Fundamentally, market mechanisms cannot prevail with the predominance of state ownership, whose controlling parties are ranked in a single hierarchy with the party and state hierarchies overlapping with each other (see Kornai, 1992: ch. 3).

Affinity 3

The third affinity is between bureaucratic coordination and the phenomena of soft budget constraint (SBC), investment hunger, shortage or inflation, and so on. Kornai argues that all these phenomena, which are often and rightly attributed to the poor performance of the former socialist systems, are directly caused by bureaucratic coordination and are also indirectly induced by institutional arrangements; that is, a party state and predominance of state ownership. SBC refers to the phenomenon where an economic agent is not afraid of future economic losses because he expects to be bailed out by the supervising government agency. SBC is also a natural reason for the phenomenon of investment hunger since SBC implies that economic agents are not completely accountable for financial losses. According to Kornai, SBC is caused by the fact that, in a bureaucratic hierarchy, the supervisor is like a parent and the subordinates are like children. The parent needs to persuade the children to take many actions and thus has to take care of them. Kornai refers to this as paternalism in a bureaucratic hierarchy. Thus, when an economic agent (child) is in financial trouble, the supervising agency (parent) naturally has to come to the rescue.

Market socialism in China

A most important implication of this analysis of the socialist system is that, without a fundamental change in the political system, it is impossible to reform the socialist economic system and improve its performance. Put simply: politics and the economy are intrinsically and coherently related and therefore it is impossible to change one without the other.

However, China's experience of reform seems to constitute a set of contradictions to the theory and its predictions. For that matter, the same can be said about the Vietnamese economic reform experience. First, the first affinity – between the undivided power of a Marxist–Leninist ruling party and the predominance of state ownership – seems to have been seriously undermined in China. While, the institution of the party state is still in place, the share of state property has been declining steadily in the Chinese economy. The non-state enterprises, which have long taken over dominance of the state enterprise, include collective enterprises, Sino-foreign joint ventures, and purely private domestic enterprises. A set of statistics paints a clear picture of this. For example, in terms of total value added, the share of industrial output by state-owned enterprises has declined from over 70 per cent in 1978 to less than 25 per cent in 2004. Parallel with this decline, there is a significant decline in the share of employment in state-owned enterprises. The same trend has been true in relation to tax revenues and fixed asset investment, although the extent of reduction in this regard is less dramatic.

The dramatic reduction of the share of state ownership, which, over time and *de facto*, has eliminated the predominance of state property, has happened without undermining the political dominance of the Party, which still has comfortable control of political power, the military force, and ideology. In fact, often in recent years, Chinese governments, especially local governments, have actively advocated faster growth of private economic activity as a spur to faster overall economic growth and to provide employment.

The decline in state ownership in the economy renders the second affinity – the close relationship of state ownership of property with bureaucratic coordination – no longer that relevant in China. With the share of state ownership shrinking, more economic agents are no longer state employees and are no longer part of the bureaucratic hierarchy. Thus, one expects decreased influence of bureaucratic coordination mechanisms in the economy. One prominent example is the recent round of macroeconomic adjustment programmes aimed at cooling the macroeconomy. In comparison to the previous rounds of similar efforts to combat accelerating macroeconomic tendencies, in 2004 the government had to rely more on market-oriented instruments to achieve its goal, including interest rate hikes and higher reserve requirements for commercial banks. This is not to say that the government is completely reliant upon market instruments. In fact, the government did use bureaucratic and administrative means to implement its goal, including a temporary suspension in approving changes of land usage from agricultural to non-commercial use. Many other examples of the diminishing role of bureaucratic control followed; such as, in varying degrees, free entry into many industries including foreign trade, free currency convertibility for trade purposes, free labour mobility for employment.

It should be emphasized that all these actions have taken place after a lengthy process of piloting with the main objective of the government being not to lose overall political control of the system. In all cases, relaxation of control was ultimately achieved without jeopardizing the government's political control.

Finally, due to the changes discussed, the third affinity – that between bureaucratic coordination and the phenomena of soft budget constraint – has also become less relevant to China. Certainly, in China today SBC still plagues state-owned enterprises, as Kornai's theory predicts. This creates macroeconomic problems for the economy, causing rounds of economic overheating and inflationary pressures. However, with the economy becoming less reliant on state-owned enterprises and on bureaucratic coordination, the phenomenon of SBC, although it still exists, is becoming gradually less damaging to the overall performance of the economy. The majority of enterprises are non-state-owned and face much harder budget constraints than their counterparts in the state sector; they are, therefore, more prudent and cautious in their investment decisions. As a result, investment hunger has been less of a problem in China in recent years. Rather than shortage or inflation, in some years deflationary pressure emerged as a major macroeconomic challenge to China's macroeconomic policy-makers.

In summary, the history of China's economic reform has been somewhat different from that of former European and Soviet socialist economies. So far, China seems to have avoided many problems that those other countries have experienced in their reforms aimed at establishing a market socialist economy.

Initial political conditions

To explain the reform experiences of China and Vietnam, we start with the two most important features of the Communist Parties in China and Vietnam in comparison with their counterparts in Eastern Europe and the former Soviet Union:

- The Communist Parties in China and Vietnam obtained national power through much more torturous, brutal, and longer military campaigns than their counterparts in Europe.
- The Communist Parties in China and Vietnam are rooted in a considerable less educated and poorer society than those of Eastern Europe and the former Soviet Union.

These two fundamental features have been critical in shaping the behaviour and performance of the Parties during reform, and make the

Communist Parties in China and Vietnam not only more stable in political control, but also economically more efficient in maintaining political control than their counterparts in Eastern Europe and the Former Soviet Union.

The Chinese Communist Party was founded in 1921 and assumed national power 28 years later in 1949. During this extended period, the Party in the first few years played a supportive role in the Nationalist Party's military campaigns. In 1927, the Party established its own independent military force and, since then, has led continuous military campaigns against foreign and domestic enemies. These military campaigns in most years were unnecessary, not only in terms of assuming political power, but also for the survival of the Party. The campaigns were often very intense and survival depended on a few critical battles. From the early years, the military experience provided the Party with a strong survival instinct, making it ideologically adaptive, organizationally strong and, naturally, militarily powerful by the time it assumed national power. For the 30 years following the Communist Party's assumption of national power, China experienced the three years of the Korean War in the early 1950s, the Taiwan Straight conflicts in the late 1950s and early 1960s, Sino-Indian border conflict in the early 1960s, Sino-Soviet border conflict in the late 1960s, and Sino-Vietnamese border conflict in the late 1970s.

Vietnamese Communist Party military experience is comparable with that of the Chinese Communist Party in terms of its duration and brutality, and began during the Second World War, in order to end the Japanese occupation. After the Second World War, the Party's military struggle lasted a further 30 years; first, against the French and then, for approximately 20 years, against the United States and its puppet South Vietnamese government until the Party claimed victory in 1975.

By contrast, the Communist Party in the former Soviet Union and those in Eastern European countries had a history of much briefer military action before they assumed national power. The Soviets obtained their national power basically through a worker's uprising supported by mutinous military action. After claiming national power, it took the Soviets less than a decade to achieve fully consolidated political control. After the Soviets obtained full political power, they were tested militarily during the Second World War, which, for them, lasted less than five years. As for the Eastern European Communist parties, most of them were politically legitimate entities in national politics, occupying or vying for seats in parliament and not resorting to military means to claim political control. This is illustrated in Table 12.1. During the Second World

Table 12.1 Years of military action by Communist parties in Eastern Europe, Russia and Asia before national power assumed

Country	Starting date of military action	Date national power assumed	Years of military action before national power assumed
Albania	1941–11	1944–11	3
Bulgaria	1943	1945–11	1
Czechoslovakia	1944	1945	1
German Democratic Republic	N/A	1945	0
Hungary	1944	1945	1
Mongolia	N/A	1921	0
Poland	1942–1	1944–7	<3
Romania	1944–8	1944–10	<1
Russian	1917–10	1921	5
Average of the European and Mongolian countries			**1.67**
China	1927–8	1949–10	23
North Korea	1932	1953	21
Vietnam	1944	1975	31
Average of China, North Korea and Vietnam			**25**

War, the national defence movements in these countries forged strong Communist parties. However, the military campaigns lasted, at most, five years. It is also a fact that in many of these countries, without the support of the former Soviet Union – which negotiated with the UK and the USA on the post war geo-political configuration of the world – it would have been difficult for the Communist parties to achieve national political power.

In sharp contrast to East European counterparts, the Chinese Communist Party is an indigenous political entity. Founded by a dozen Chinese intellectuals, in its early years, the Party actively sought assistance from the Communist League for political and military advice. However, international assistance quickly proved to be counterproductive, leading the Party into a sequence of deep military troubles and, consequently, infighting among the leadership. By the middle of the second decade of the Party's history, indigenous leaders secured their complete control of the Party and never fully trusted the advice of foreign Communist authorities. For example, the Party defied Stalin's instruction to follow the Korean model in order to obtain control over only half of the country. Instead, the Party liberated the whole country in 1949, except for a few scattered regions. In Eastern Europe, without the direct and strong support of the Soviet Union, many former socialist regimes could not have been established.

It is clear from this brief historical review that both the Chinese and the Vietnamese Communist Parties had clear nationalistic agendas during their extended efforts to achieve national power. In the Chinese case, the agenda was to drive out Western powers that had invaded China following the Opium War in 1840. The peak of this campaign was the Anti-Japanese War from 1937–45. In the Vietnamese case, it was to drive out the French colonists and, later, the American imperialists.

Adding to the political strengths of the Chinese and Vietnamese Communist Parties is also the fact that they are both rooted in much less educated and poorer societies than their European counterparts. Illiteracy was widespread in China and Vietnam. Until recent years, with per capita GDP only a few hundred US dollars a year, China and Vietnam were among the lowest income countries in the world. These two countries were still traditional societies with agriculture being the most important sector in these economies. This fact was clearly factored into the Chinese Communist Party's political platform before they assumed national power. For instance, the Chinese Communist Party made it explicit that their military campaign in order to win national political power was no different to those endless peasant revolts in China's long feudal history. In fact, the majority of the Party members were from peasant backgrounds. The Party promised and, indeed, implemented land reform, dividing landlords' land and giving this to the peasants. This made the Party politically popular and deeply rooted in the society. Moreover, a poorer and less educated population is much less demanding with regard to political rights for the sake of political freedom, and is more focused on basic economic subsistence and the improvement of material life. This is in sharp contrast to most Eastern European countries, which have a tradition of representative government. The value attached to, and the demand for, political freedom has been far greater in Eastern Europe since the bourgeois revolution in 1848.

There are direct and important implications following these fundamental features of the Communist parties in China and Vietnam. The first is that the Chinese and Vietnamese Communist Parties were much more stable and secure in their political position at the onset of the economic reforms. They faced less threat of being overthrown by internal or external political or military forces than Eastern European Communist parties. Years of brutal military fights had rendered them politically and militarily strong.

Second, they are much more economically efficient in maintaining political control. Fewer economic resources are necessary to maintain the same level of political control due to a less educated population, whose concerns are mostly economic rather than political. Also, an indigenous political party finds it easier to justify its legitimacy than a foreign imposed party. A nationalistic agenda together with a long history of a feudal political system make it easier to maintain political control using relatively fewer economic resources.

The model and analysis

We set up a model to be more precise in our analysis. The model consists of the ruling party and the general public (the population) as two agents who have different preferences. The ruling party's preference puts a positive weight on political control as well as total social wealth, while the general public cares about social wealth but dislikes political control.

The political PPF curve and threshold level of political control

There is a trade-off between political control and total wealth in the way that a higher level of political control leads to a less efficient economy and thus a lower level of total wealth in the country. This trade-off, plus the assumption of an increasing marginal cost of political control, gives a conventional concave curve similar to the production possibility frontier (PPF) curve.

For the ruling party in a socialist country to stay in power, a threshold level of political control, $C = C^*$, is needed. When $C < C^*$, the ruling party collapses and the level of political control becomes 0. Therefore, the feasible set of the choices for the ruling party is the point 0 plus the set of (C^*, ∞).

The general public can incur a rebellion cost, R, in waging substantial resistance to the ruling party's control. Suppose that, once this cost is incurred, the general public can successfully change the government and the political system. We call this a drastic political reform. However, the general public compares the total cost R and the potential benefit of such a drastic political reform to decide what the gain is; that is, $\Delta u = u^m - u^*$, where u^m is the level of the general public's welfare achieved at political control being 0 and u^* is the welfare before the drastic political reform. This is shown in Figure 12.1.

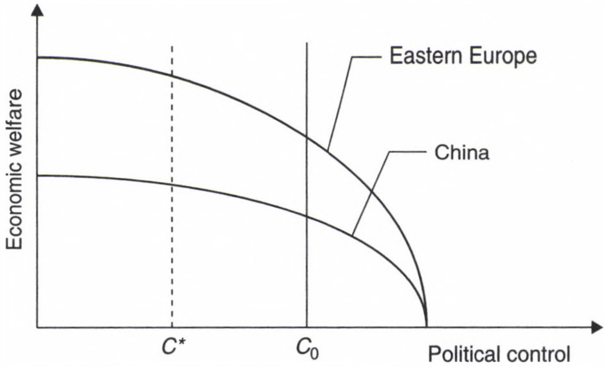


Figure 12.1 PPF-type trade-off between economic welfare and political control

Notes:
1 C* is the threshold level of political control in order for the ruling party to stay in power;
2 C_0 is the initial level of political control before reform starts;
3 Eastern Europe can achieve a higher level of economic welfare when political control is completely lifted;
4 For the same level of political control, China and Vietnam achieve less economic welfare; that is, they are more efficient in political control.

Initial conditions

Before the reform, the level of political control is at C_0, which is above the threshold level of control C^*. We assume that both China and Eastern Europe were at the same level of C_0. The initial level of political control might not be optimal from the ruling party's perspective. In fact, we assume it is too high for the ruling party's own best interest; that is, the ruling party is sacrificing too much economic welfare to maintain this much political control. This is the starting point of our analysis.

For simplicity, the model focuses on one difference in initial political conditions between China and Eastern Europe, as illustrated by the two PPF's in Figure 12.1. Suppose that the PPF's are such that when political control is maximal, social wealth is 0 for both countries. However, in the other extreme, when political control is minimal at $C=0$, Eastern Europe with a better educated population and better other initial economic endowments can achieve higher wealth than China. In between, at each level of political control, the slope of the PPF is steeper for Eastern Europe than for China, meaning that China has a more effective political control system and thus needs fewer resources to achieve a given level of political control.

The decision by the government to reform

In order to simplify the analysis of the ruling party's decision to reform, we reduce the potentially complicated game between the government and the general public to a simple optimization decision problem for the government. The government maximizes its own objective function by choosing a new level of control C subject to two constraints. The first constraint is that C must be either 0 or in the interval of (C^*, ∞), since any level of C between 0 and C^* is not feasible.

The second constraint comes from possible resistance from the general public. The optimal choice of C cannot be such that it invites the general public to rebel against the government that is, the optimal choice must satisfy the condition that $\Delta U = U^m - U(C, w) \leq R$. Otherwise, C cannot be optimal for the ruling party, since it causes the ruling party to lose power, forcing $C = 0$.

As a technical assumption to facilitate our analysis, we assume that the objective function of the government is in the quasi-linear form of $G = g(C) + w$, where $g(.)$ is a concave function. The interpretation is that when the level of political control is low, the ruling party derives high marginal benefit from increasing it. Similarly, we also assume that the general public's preference can be represented by a quasi-linear utility function in the form of $U(C, w) = u(C) + w$. We need these technical assumptions in order to derive the following results in a convenient way. These assumptions are not necessary and can easily be relaxed. All we need is to ensure that the marginal utility from w does not decrease too fast.

To summarize, we have the government's choice of reform:

$$\text{Max } G = g(C) + w$$

$$\text{s.t.} \quad C = 0 \text{ or } C \geq C^* \tag{1}$$

$$u(0) + w^* - u(C) - w \leq R \tag{2}$$

$$(C, w) \in \text{PPF} \tag{3}$$

Predictions of the model

The purpose is to compare the optimal choices of the governments in the two groups of countries. In order to do this, we first analyse the problem without constraints (1) and (2). First, we observe that the government's optimal choice problem facing only constraint (3) is a standard one to be found in economics. It is well defined and should have a unique solution under the assumption of strictly concave PPF. Furthermore, given

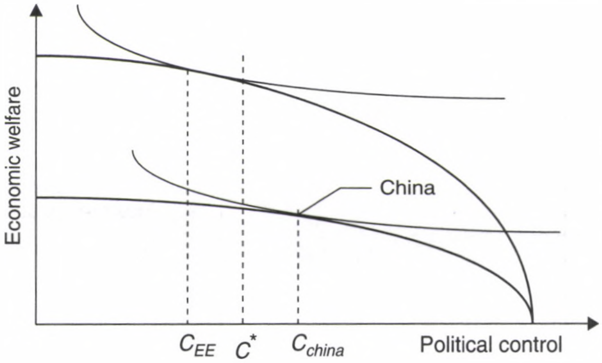


Figure 12.2 Government's reform decision without the control threshold constraint

Notes:

1 In the figure, because the steeper PPF-type tradeoff curve, the Eastern European government's choice C_{EE} is below the threshold level C^*; this is without the constraint that C cannot be smaller than C^*;

2 With the threshold constraint, the Eastern European government either chooses C^* or 0;

3 The Chinese and Vietnamese government choose $C_{China} > C^*$ due to their relatively flat PPF-type tradeoff curve.

the quasi-linear objective function of the government, the optimal decision problem with only constraint (3) should have an optimal *C* lower for Eastern Europe than for China. See Figure 12.2 for an illustration. Intuitively, the difference between the two groups of countries is roughly similar to the situation where *w* is a commodity that is cheaper in Eastern Europe than in China. Thus, the optimal choice for Eastern Europe is a higher *w* and lower *C*.

Second, let us add in constraint (1), which is the same for both China and Eastern Europe. Note that the problem facing only constraint (3) is standard, and the value of the objective function constrained to condition (3) should be single-peaked. Thus, the problem with constraints (1) and (3) should generally be a higher optimal choice of *C* if the original problem with only constraint (3) is higher. Therefore, without considering condition (2), the optimal choice of *C* of the ruling party in Eastern Europe should not be higher than China. Intuitively, the reason is that, without considering the threshold of control, the European optimal level of political control is lower than that of China. Since the threshold constraint is the same for both sides, with the constraint, the optimal choice of *C* should have the same pattern.

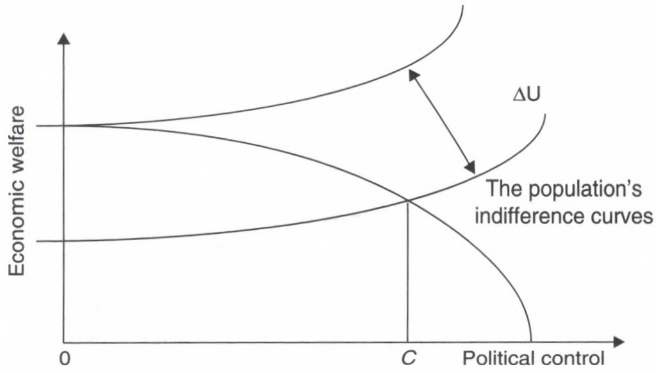


Figure 12.3 Population's decision to resist political control

Notes:

1 The two indifference curves of the populations are associated with political control at the levels of C and 0, respectively;

2 ΔU is the welfare gain the population can obtain by changing political control from C to 0;

3 If ΔU is bigger than the rebellion cost R, the population decides to resist political control.

Finally, we put in constraint (2). It is obvious that this constraint is automatically satisfied at $C=0$, which is a feasible choice. Note that, by assumption, the efficiency of political control in China is higher, or, the slope of their PPF is flatter. This implies that $w^* - w$ is lower in China. Thus, constraint (2) is more likely to be satisfied at any point of $C > C^*$ for China. Therefore, it is more likely for Eastern Europe to have $C=0$ as the optimal choice than China. Intuitively, since the general public's economic gain from political resistance is lower in China, the ruling party is more likely to choose $C > 0$ as its optimal reform choice without revoking resistance.

To summarize, we have the following two predictions:

- It is more likely for Eastern Europe to choose $C=0$ as its optimal reform objective.
- It is more likely for China to choose $C \geq C^*$ as its optimal reform objective.

Interpretations

The theoretical analysis predicts that the Eastern European countries are more likely to choose $C=0$; that is, drastic reforms to yield political control. In the model, this can either be a voluntary choice by the government without considering the resistance constraint (3) or this is due to constraint (3), which in this case says that any level of $C \geq C^*$ is unsafe for the government. This is consistent with the experience of these countries. In most European countries, the government gave up their power somewhat peacefully and, in many cases, almost voluntarily, without big military fights. Even in the case of the former Soviet Union, there was no blood shed during the 1991 crisis that led to the subsequent collapse of the Soviet Union. China and Vietnam, by contrast, have experienced much lower popular resistance to continued political control by the ruling party than Eastern Europe and the former Soviet Union. In China and Vietnam, there have been no reports, by either domestic or foreign media, of large-scale protests for drastic political reform, let alone demonstrations for regime shifting change. The Tiananmen Square incident in the spring of 1989, which was by far the most drastic and dramatic popular political protest in the history of the People's Republic of China, cannot possibly be identified with those events such as the Prague Spring in the former Czechoslovakia and the Hungarian Event. The incident in Tiananmen Square was mainly caused by popular resentment against widespread corruption associated with the dual-track pricing reform and high inflation (by Chinese standards). Students and protestors who joined the cause throughout the whole process never demanded drastic political change. In fact, some even waved banners saying that they supported the rule of the Party. None of the protesters voiced calls for free political party registration or open political election.

The analysis based on the model also predicts that countries such as China and Vietnam are more likely to implement reforms that reduce, rather than completely eliminate, the ruling party's political control. This is also consistent with what happened in these countries. In either China or Vietnam, from the onset of reform, it was clear that reform would take place under the leadership of the ruling party. In the Chinese case, Deng Xiaoping made it the first of the four most important and most fundamental principles of reform that the Communist Party must maintain its leadership position. As a consequence, the government has been very cautious of organized protests, whether about pure economic interests or political demands. The Tiananmen Square incident was crushed by military force in order to eliminate any political instability. Similarly, organized religious activities not included on the government-approved list have been carefully monitored and, in principle, not allowed. In fact, in the Chinese case the central government's objective of preventing any overt challenges to the existing political regime is shared by local governments, even though the latter often have distinct

Table 12.2 The share of industrial output: state sector and non-state sectors (%)

Year	State enterprises	Non-state enterprises
1985	64.90	35.10
1986	62.27	36.63
1987	59.72	40.28
1988	56.79	43.21
1989	56.06	43.94
1990	54.60	45.40
1991	56.17	43.83
1992	51.52	48.48
1993	46.95	53.05
1994	37.33	62.67
1995	33.97	66.03
1996	36.32	63.68
1997	31.62	68.38
1998	49.63	50.37
1999	48.92	51.08
2000	47.34	52.66
2001	44.43	55.57
2002	40.78	59.22
2003	33.04	66.96

Source: Li (2006), table 1.

economic interests relative to those of central government, since the most important criterion for promotion or demotion of a local government official is whether or not s/he is able to maintain political stability in his or her jurisdiction.

While keeping the same political regime intact, China and Vietnam have implemented market-oriented economic reforms that have seen a significant reduction of government control in major economic decisions. A set of statistics paints a clear picture of this. In terms of total value added, the share of industrial output by state-owned enterprises has reduced from more than 70 per cent in 1978 to less than 25 per cent in 2003. During the same period, the share of employment of state-owned enterprises decreased from 80 per cent to 25 per cent. See Tables 12.2 and 12.3. In terms of tax revenue and fixed asset investment, however, the extent of reduction in the share of state enterprises is less dramatic.

The diminishing dominance of state property in the Chinese economy is through a long and mixed evolutionary process. Sometimes, the government is forced to privatize or liquidate state enterprises in order to alleviate the fiscal burden. On other occasions,

Table 12.3 The contribution to industrial growth: state sector and non-state sectors (%)

Year	State enterprises	Non-state enterprises
1985	64.86	35.14
1986	62.27	37.71
1987	59.72	40.28
1988	56.79	43.21
1989	56.06	43.94
1990	54.60	45.40
1991	56.17	43.83
1992	51.52	48.48
1993	46.95	43.05
1994	37.33	62.67
1995	33.97	66.03
1996	36.32	63.68
1997	31.62	68.38
1998	28.24	71.76
1999	28.20	71.80
2000	11.10	88.90
2001	22.11	77.89
2002	17.73	82.27
2003	20.00	80.00

Source: Li (2006), table 2.

non-state enterprises happened to grow much faster than state enterprises. On yet other occasions, the Chinese government advocated and actively supported faster growth of private economic activities in order to spur faster overall economic growth and to provide employment opportunities.

Conclusion

We have revisited the issue of China and Vietnam compared to Eastern Europe and the former Soviet Union and their approach to economic reform and transition. We have noted that China and Vietnam represent a fundamental puzzle for students of the former socialist economies.

We have resolved the puzzle by observing some fundamental differences in initial political conditions between the two groups of countries, while existing works have focused on the initial economic and organizational differences. The first fundamental difference is that the Communist parties in China and Vietnam had experienced long and extremely brutal military campaigns before assuming national power. The second fundamental difference is that the Communist parties in China and Vietnam are indigenous parties deeply rooted in ill-educated and poor societies with long feudal histories. These differences give rise to the fact that the Communist parties in China and Vietnam are more solid and more efficient in political control than their counterparts in Eastern Europe and the former Soviet Union.

Our view is that these fundamental differences in the initial political conditions determine the differences in the path of reform. In China and Vietnam, the government is much less inclined to give up political control and the general public's level of resistance to the existing political system is much lower than in the other group of countries. As a result, the ruling parties in China and Vietnam are much more likely to implement reforms that reduce, but not fundamentally alter, the political system; their European counterparts are more likely to give up the political system peacefully.

Our analysis suggests that the incompatibility between the political system of the former socialist systems and market economy need not be as restrictive as the Eastern European experience suggests. In countries with initial political conditions such as China and Vietnam, there is room to reduce political control without changing the political system and, at the same time, push for significant progress in market-oriented economic reform.

References

Kornai, János (1992) *The Socialist System: The Political Economy of Communism* (Oxford: Oxford University Press).

Li, David D. (2006) 'A Survey of the Economics Literature on China's Non-State Enterprises', in Tsui, Ann and Cheng, Leonard (eds), *Studies of China's Privately Owned Enterprises* (New York: M.E. Sharpe).

Qian, Yingyi; Roland, Gérard and Xu, Chenggang (1999) 'Why Is China Different from Eastern Europe? Perspectives from Organization Theory', *European Economic Review*, 43(46): 1085–94.

Sachs, Jeffrey and Wing T. Woo (1992) 'Structural Factors in the Economic Reforms of China, Eastern Europe, and the Former Soviet Union', *Economic Policy*, 9(18): 101–45.

Sachs, Jeffrey; Wing T. Woo and Xiaokai Yang (1999) 'Economic Reforms and Constitutional Transition', mimeo, Harvard University.

Index of Names

Subject Index

palgrave
macmillan

One of the most important legacies of the twentieth century is the rise and fall of the socialist economic system. While countries in Central and Eastern Europe have abandoned socialism and embraced market and democracy, two Asian countries – China and Vietnam – appeared to have followed a different path, and both economies are growing fast. Yet, although both China and Vietnam are making a decisive transition to the market economy, they have also insisted on the official ideology of socialism. The reform experiences of these two countries have raised important intellectual questions: Are China and Vietnam practising market socialism? How has the 'market' emerged under the ideology of socialism? What is the meaning of the market in this context?

This book brings together a wide range of experts to address these questions by studying some of the fundamental issues surrounding the relationship between the market, property rights and socialism. With fresh insights into these important and topical issues, this book contributes to an understanding of how the market and socialist ideology coexist in China and Vietnam, while also drawing important conclusions which have implications beyond these regions.

János Kornai is Permanent Fellow Emeritus at Collegium Budapest Institute for Advanced Study, Hungary, and Allie S. Freed Professor of Economics Emeritus at Harvard University, USA. He is the author of many other books, including *The Economics of Shortage* (1980) and *The Socialist System* (1992).

Yingyi Qian is Professor of Economics at the University of California, Berkeley, USA, and the School of Economics and Management, Tsinghua University, Beijing, China.

ISBN 978-0-230-55354-5
90101
9 780230 553545

Printed in Great Britain