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# Options for Market Reforms in China

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# Review Article: Options for Market Reforms in China\*

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## Introduction

Most of the former planned economies are in the midst of major economic transitions. In these economies the questions being addressed no longer deal with whether or not they should reform—their very economic survival and future development rest on how to proceed with reform. In the former Soviet Union and eastern Europe, the questions are down to nuts and bolts: how to privatize and encourage market behavior quickly before chaos clouds the situation further. In China, the leadership is attempting to improve efficiency via small scale private ownership and markets while preserving the state sector.

Similarity between the two situations ends there. The countries of the former Soviet Union and eastern Europe are concerned with building capitalism and democracy. In contrast, China's goal is to create a "socialist market economy" with "Chinese characteristics."<sup>1</sup> Reform is deliberately gradual, with increasing market transactions but without turning control or ownership of state-owned enterprises over to the private sector. The intent is economic, not political, reform. Western observers tend to be critical. Many believe that China's gradual approach has created a host of new problems and that political change is a necessary condition for successful economic reform.

Two new books examine problems of socialist planned systems generally and discuss solutions that specifically pertain to China. *Reform in China and Other Socialist Economies*, by Jan S. Prybyla, is a collection of 18 essays written in the 1980s. Prybyla argues that until China has fully functioning markets and political freedom, economic reform cannot succeed. Henry K. H. Woo, in *Effective Reform in China: An Agenda*, develops a new framework for China that identifies farmer-entrepreneurs as the key to sustained development. Woo is willing to discuss the possibility of reform within China's existing political framework; Prybyla is not. However, both authors argue

strongly that socialism as a political-economic system is a dead end and that China's reform experience to date has not been successful. China's leaders would take exception to both assessments.

### **China's Reform Experience**

Why have many former planned economies taken on fundamental system reform? Both Woo and Prybyla believe internal factors rather than outside pressures led to reform. In Prybyla's words, the crisis "is first a problem of Marxism, of the system's philosophical assumptions and second a problem of the institutional structures built on these poor foundations" (p. 3). In Woo's view, "a planned economy produces degenerative moral qualities that ultimately defeat the system itself" (p. 104).

The authors' criticisms are equally harsh for China's reform efforts throughout the 1980s. Prybyla's chapter 13, first published in 1989, is entitled "Why China's Economic Reforms Fail." He argues that socialist systems perpetuate shortages and waste and destroy innovation and individual incentives. Prybyla contends that the problem with reform efforts in socialist systems generally is that they do not go far enough, or fast enough. Put differently, the underlying purpose of reform is usually wrong. Reforms typically represent policy changes and minor system adjustments but do not fundamentally alter ideas or institutions. Minor change has characterized China, he argues, not real reform.

Prybyla singles out agriculture between 1979 and 1984 as one of China's few reform successes. He points out that agricultural output, productivity, and income all increased significantly. This positive evaluation is tempered, however, by the caveat that they "must be measured against the very low levels of the preceding collectivist decade" (p. 172). Chapter 10, "China's Economic Experiment, from Mao to Market," is the most positive. This chapter, however, was originally published in 1986 and probably was written before Prybyla came to believe that China's reforms were on the wrong track.

Woo is also critical of socialism. His chapter 2, "The Bankruptcy of Practical and Theoretical Socialism," acknowledges the now common critiques of socialism with respect to planning, incentives, property, and waste. He then goes further: "I will contend that whereas a capitalist system, contrary to popular belief, has the capacity to turn private vice into positive moral qualities, a socialist system unleashes nothing but the vicious parts of human nature" (p. 102).

Like Prybyla, Woo believes China's reforms did not go far enough. He argues that changing incentives through household and enterprise contracting was a step in the right direction. As signs of China's progress, he discusses allowing the emergence of a private sector, introducing material incentives, altering production to meet

consumer demand, and encouraging foreign capital. Woo argues, however, that these positive steps were undermined by constraints and counter motives. For example, reforms did not end—perhaps even increased—the need for enterprise managers to protect their jobs by supplying their political bosses with material goods. Thus the incentives for corruption overwhelmed the incentives for efficiency and profitability. Likewise, China introduced a profits tax to replace profit remittance. With a profits tax, enterprises would retain the after-tax profits and therefore have an incentive to lower production costs. Despite good intentions on the part of those in China supporting the profits tax, Woo argues that this simply introduced a new arena for bargaining—in this case, the effective tax rate.

For both authors, 1984 was the critical year when China's reforms began to sour. Woo specifically identifies why reform at this juncture was incomplete. He points out that China's basic mistake was that the center continued price control at the same time that it gave other types of economic powers to firms and local governments. This unfortunate combination, he argues, led to more, rather than fewer, irrationalities because enterprise decisions were based on nonmarket prices. In addition, the reforms shifted to industry instead of building on the successes in agriculture in the early 1980s. The result was a plethora of imbalances, both monetary and real, that caused many to wonder if this was the end of China's orderly experiment. The Tiananmen student demonstrations in 1989, which ended in a bloody crackdown, fueled those fears.

But are Prybyla's and Woo's harsh evaluations of China's economic reforms warranted? Taking private economic activity as just one measure of decentralized decision making, there is evidence that China has made progress. According to an article in *Beijing Review*, "the private sector of the national economy has developed rapidly and [has] become an attractive form of the non-public economy."<sup>2</sup> According to this source, by mid-1991 there were 98,812 private businesses employing over a million and a half people.<sup>3</sup>

One way to gauge the extent of private activity is to recast China's statistics to measure production by private firms as a percent of GNP. First, using a narrow definition of private firms in China, the so-called individual households or *geti hu*, the private sector in industry and services combined represented 7% of GNP in 1989.<sup>4</sup> If agriculture is included, where production and marketing decisions are largely determined by the households that contract land, the private sector represented 34% of GNP in 1989.<sup>5</sup> And if collective industry and services are added, many of which function as private firms but are officially registered as collectives, then the percentage of GNP that was produced by the private and quasi-private sectors in 1989 was 63%.

Even these figures cannot be taken at face value, however. Unlike

the former Soviet Union and eastern Europe, China's privatization of industry and commerce has meant expansion of the nonstate sector or issuing shares with a controlling interest in the hands of government institutions. Privatization has not meant selling state-owned enterprises to private individuals. Both Prybyla and Woo point out that property rights are not well defined and that markets are primarily transactions in final goods, with markets in factors of production remaining less developed. Nonetheless, the future may find us reevaluating the Chinese case. It may be that fundamental reform will evolve because increased decision making by firms, households, and individuals is actually occurring more than is visible to foreigners or acknowledged by Chinese.

### **How Fast?**

Contrasting China's reform experience with those of the former Soviet Union and eastern Europe also raises questions of speed. Can reform be gradual, as China's leaders prefer, or is the only road to successful reform the "shock therapy" variety? Western economists tend to favor the shock approach for economies trying to make major structural transitions, although a few have argued that China has achieved some success without it.<sup>6</sup> Prybyla falls into the shock therapy camp. According to him, the slow pace has caused reform in China to create "more problems than it solved" (p. 235). Some of these problems are of course expected; the real question is how long they will persist and if their existence will jeopardize further reform.

On the question of speed, Woo implies that going slowly is merited when markets need to be developed in rural areas. A slower pace could avoid polarization of income by sector and class and avoid situations of oversupply because purchasing power would have time to rise. In his view the crucial question is the choice of the appropriate combination of reforms and their simultaneous implementation, not the pace of reform per se.

Related to the question of speed is the feasibility of a market socialist system incorporating some mix of plan and market. Neither Prybyla nor Woo believes that planning contributes anything to economic development. In the past, China's leaders have implied that the role of directive planning was to decrease but to be retained. Over time, China's commitment to planning seems to have weakened. The Fourteenth Party Congress in October 1992, accepted achieving a market economy as an explicit goal. However, planning is still done in China and may have even increased at local levels in some areas.<sup>7</sup> Hence, China will be dealing with the effects of a mixed plan-market system for some time to come.

### **China's Choices**

Since Prybyla believes that no mix of market and plan can work, he recommends markets as the only answer, and the sooner the better. He

also contends that no system without democracy is desirable. Market socialism, then, is a false concept. He does not analyze what the transition process might look like. In fact, he states that in the process of moving from planning to markets, "there is no need to know the exact topography . . . just the general direction and the destination" (p. 300). The strength of his prescription lies in its consistency and his thorough criticism of nonmarket systems.

The closest Prybyla comes to a concrete proposal is in a chapter comparing mainland China with Taiwan. After showing the dismal economic performance of the mainland compared with Taiwan, Prybyla suggests that Taiwan's economic system could serve as a model for the mainland. He describes this system as "capitalism with Chinese characteristics" (p. 262). He warns, however, that to adopt this system successfully, China would have to accept all of the pieces, including individual economic and political freedom.

Like Prybyla, Woo believes that the ideal end for China's reforms is a free market system. In contrast to Prybyla, however, he discusses in much greater depth what the reform process might look like. Woo's ideas are also novel in that they go beyond standard prescriptions of macrostabilization and micro efficiency. In the rest of this article I explain and evaluate his comprehensive attempt to understand China's particular situation and contribute fresh proposals.

As a basis for his proposals, Woo develops specific concepts of capital and morality, which he argues are essential to feasible development. Feasible development, in turn, can be attained by many developing countries by using a strategy centered on agriculture.

For Woo, development depends on an inclusive concept of capital. "Inclusive" capital comprises physical and human capital in conjunction with a vision of the future. In contrast, Woo uses the term "anticapital" to refer to human qualities that hinder development: mistrust, suspicion, irresponsibility. These anticapital qualities can lead to "hazards" in development such as rent seeking, inflation, and corruption. Woo argues that development strategies that are not based on an inclusive concept of capital risk failure. This is because "certain subjective qualities—for example, desire for material gains—being neutral in themselves, are capable of being converted into either capital or anticapital depending on the specific socioeconomic conditions under which they operate" (p. 126).

Woo makes a case that agriculture should be the basis of development in countries where farming is the major economic activity. Focusing on agriculture will foster farmer-entrepreneurs, who represent critical human capital of the inclusive type, and will minimize the hazards of development that typically arise from urban industrial based approaches. Woo's strategy depends on building "effective" agriculture. An essential ingredient is a class of farmers who willingly invest in new productive techniques to raise output and productivity. Also needed

is a mode of agricultural production that is "insurance intensive." Insurance intensive means a system that organizes society to share the risks of climate and pests, and to invest in environmentally sustainable agriculture.

In the case of China, Woo's support of a new "agriculture first" strategy goes beyond China's large agricultural base. At this juncture in China's reform, Woo finds that agriculture "remains the only area free of the contagious irrationalities of the urban industrial system, and is also the only area on which favorable conditions for a comprehensive reform could gradually be reinstated" (p. 207). And yet, effective agriculture is far from a reality in China, according to Woo, because there is no class of farmer-entrepreneurs willing to invest in the future of agriculture and because current farming methods are a long way from allowing risk sharing and from being environmentally sound.

To develop a class of farmer-entrepreneurs, Woo suggests that China use agromanagers. These managers would be consultants in agrobusiness, suggesting new technologies, management techniques, and solutions to inventory and storage problems. At first these services would be subsidized by the government. Eventually, however, Woo believes that farmers would come to appreciate these services and be willing to pay for them as a form of investment.

Woo's proposals on how to develop an insurance-intensive agriculture are less specific. Production would be small-scale and labor intensive. It would combine knowledge farming with the more common natural, organic, and chemical forms of farming until the ideal type of production could be worked out.

Although Woo's goal is a free market system, he clearly sees a role for government in the transition from China's planned, semi-reformed system. For Woo, the central government is the appropriate level to orchestrate the agricultural strategy. In his view, decentralizing power to provincial and local governments has hindered reforms in China by creating local domains of resource control without decentralized market decision making. In particular, the central government would be geared toward developing the agromanagers, investing in infrastructure, and expanding interprovincial trade. At a later stage the government would also develop marketable property rights for farmers. The central government could ensure that these policies were uniform across provinces. Finally, the government would ensure that amenities of life such as health, education, culture, and leisure were developed in the countryside. Making rural areas attractive places to live would provide incentives for farmers to invest in the long term and to discourage rural-urban migration.

As rural industry has characterized China's development experience since the early 1970s, it is interesting that Woo is highly critical

of this phenomenon. Woo argues that encouraging rural industry too soon, as China has done, is detrimental to agriculture because it pulls critical resources away from farming. Further, long-term investment in farming is undermined because rural industry is profitable largely because of distorted prices carried over from the urban industrial sector. For Woo, rural industry, as well as other nonfarm activities, should eventually play a role but not until an effective, sustainable agricultural base has been firmly established.

What about the urban sector in Woo's agenda? He proposes that price irrationalities gradually be reduced through bankruptcy and free labor markets. While this is taking place, the rural economy should be insulated from these irrationalities, although Woo does not explain how this would be done. In the meantime, the rural areas should receive new investment. In this way the farming economy could be strengthened while the urban economy is reformed. Later, once the agricultural production base is firmly established and problems in the urban economy are corrected, the two could be gradually integrated via a free market system.

Since China's urban economy is the basis for international investment and trade, Woo's proposals would weaken these international links considerably. According to Woo, weakening these links might even be desirable if China's export growth has been promoted by false profits produced by a dual price structure. He also places little importance on the need to export in order to import raw materials and technology. Woo argues that since it is questionable whether these imports have been compatible with China's indigenous factors of production, having less of these costly imports need not be devastating to China's development.

Woo also suggests China should discourage agricultural exports because they are too vulnerable to uncertainties in international markets. He does, however, make a case for the promotion of the food-processing industry, including exports, once interregional trade and specialized production are developed. He emphasizes that this industry should be developed with local resources, exploiting China's large domestic market before venturing internationally.

In sum, for Woo modernization is clearly not equated with industrialization. "Modernization via the route of vigorous industrialization as a developmental pathway is a misconceived strategy, costly to attain and not sustainable" (p. 239).

#### **A New "Agriculture First" Strategy?**

Woo's arguments in favor of agricultural development are generally persuasive, although they contrast directly with China's current emphasis on an urban, coastal strategy. While China's agricultural performance has been commendable, many analysts inside and outside the



country have warned of the long-term effects of rapid loss of arable land, inadequate reinvestment in agriculture, and the deterioration of rural infrastructure.

However, Woo's proposals may be overly optimistic. For example, he argues that farming employment and productivity must increase. By this he means that land productivity must increase, not necessarily labor productivity. But how realistic is this? If capital investments increase land productivity, they could easily increase labor productivity as well, thereby creating surplus labor. Since Woo is certain that farming employment will rise through the use of labor-intensive techniques, he does not have proposals to deal with surplus labor.

Woo would also like to see the quality of life improve in rural areas to increase the payoff for investing in farming and to lessen urban migration. Unaddressed by Woo is migration pressure, which is already high in China and on the rise. Experience in other countries, such as Japan and Taiwan, suggests that a comfortable rural life is sufficient to keep the next generation from leaving. In China, wage-paying jobs in rural industry and small town development have been factors lessening the desire to migrate to large cities, but Woo does not recommend continued support to these activities at this stage of reform.

Woo argues that China needs a rural based, agricultural strategy. This would mean a major shift away from its current urban, coastal based strategy. Rural entrepreneurs have emerged in services and urban-rural trade, as Woo rightly points out, at the expense of farming. However, these activities have provided rural areas with increasing income, which has spurred new production activity. His rural based policy would also mean a smaller role for foreign investment, especially in joint ventures. Foreign investment has been a stimulus to income through expanded employment opportunities. In the long run, it is possible that agriculture could provide replacement high-wage jobs, but the transition would probably depress the economy and shatter expectations. Political ramifications could also shake urban areas, where people are already worried about the cost of living, if not their jobs. Woo does not address how the urban sector would be reformed and how people would react while resources are spent in building a solid agriculture.

Woo's proposal that the central government, not the local government, should lead the reform effort is well argued. Decentralization in China has been partial, with local governments gaining appreciable power over the center, leaving enterprises more beholden to local officials than before. With this as the midway step, markets may never develop. But is the center capable of leading such a reform? And at this point, could the center take away the powers that local officials

have gained? These are crucial questions in determining the feasibility of such a proposal, but Woo does not address them directly.

Finally, Woo leaves untouched the Cultural Revolution period. How does the legacy of the Cultural Revolution constrain or motivate the processes that Woo addresses? The connections here are potentially deep and important. Woo does not, however, discuss the extent and types of anticapital that the Cultural Revolution generated. He misses an important opportunity to explore the implications of the concept of anticapital and the development problems it generates, and thus he fails to add to our understanding of the unusual experience of China's Cultural Revolution.

### **China's Own Road**

By the end of 1993, China's path to reform conformed with the emphasis on markets that Prybyla and Woo advocate but it deviated from both their ideals in most other respects. For example, Prybyla argues that there can be no market reform without democracy. But China's Fourteenth Party Congress, in October 1992, approved comprehensive market reforms without addressing political reform. In a move to forestall political reform, the Central Committee announced just before the Congress met that Zhao Ziyang, who supported political as well as economic reform, would not be rehabilitated. In addition, throughout 1993 and early 1994, Chinese officials continued to arrest political dissidents.

China is straying from what Woo recommends as well. Preferences for industrial, urban development continue to outweigh those for agriculture. With even less support for agriculture than before, continued increases in output will be in jeopardy, as Woo correctly points out. Woo further argues that developing China's international ties should take a back seat to establishing sustainable agriculture. The reverse is happening. Not only has foreign investment in China surged in the 1990s, but enterprises of all sizes and ownerships have sought trade and investment deals with foreign companies. One motivation is that being a joint venture gives an enterprise certain benefits, including access to foreign exchange and lower taxes. In addition, China's various government levels have encouraged enterprises to become joint ventures. Few of these joint ventures relate directly to strengthening agricultural production.

More fundamentally, in contrast to outside observers such as Prybyla and Woo, China's leadership continues to promote socialism as a viable political-economic system. If they are right, then time is on their side. If they are wrong, then the external pressure of demonstration effects, combined with the momentum that already exists within China's own reforms, may end China's socialist experiment as early as the next impending leadership succession.

## Notes

\* This article is a review of Henry K. H. Woo, *Effective Reform in China: An Agenda* (New York: Praeger, 1991); and Jan S. Prybyla, *Reform in China and Other Socialist Economies* (Washington, D.C.: AEI Press, 1990). I would like to thank John Garver for his editorial suggestions.

1. Since the early 1980s, Chinese publications discussed achieving a "planned commodity economy." Throughout 1992 the term "socialist market economy" began to be used instead. At the Fourteenth Party Congress in October 1992, use of the term "socialist market economy" was officially accepted.

2. "China's Private Economy Today and Tomorrow," *Beijing Review* (December 23-29, 1991), p. 20.

3. *Ibid.*, pp. 20-21. This definition of private business appears to be *siying* firms, which are firms registered as private establishments with eight or more employees.

4. These estimates of the percent of GNP produced by the private sector are based on data from Guojia Tongji Ju (State Statistical Bureau), *Quanguo gesheng, zizhiqu, zhixiashi lishi ziliao huibian, 1949-1989* (Compilation of historical data on each province, autonomous region and independent municipality in China, 1949-1989) (Beijing: Zhongguo tongji chubanshe, 1990), pp. 4, 15, 24. *Geti hu* are businesses that use family members as workers, are located in rural villages or towns, and are engaged in production, commerce, or services.

5. According to one study by western analysts, "China's rural reform, in which communes were to some extent privatized to their members, stands as the most impressive example of property rights reform among socialist countries" (Stanley Fischer and Alan Gelb, "The Process of Socialist Economic Transformation," *Journal of Economic Perspectives* 5 [Fall 1991]: 98, n. 5).

6. Ronald I. McKinnon, "Gradual versus Rapid Liberalization in Socialist Economies: Financial Policies and Macroeconomic Stability in China and Russia Compared" (paper presented at the World Bank's Annual Conference on Development Economics, Washington, D.C., May 3-4, 1993); Kang Chen, Gary H. Jefferson, and Inderjit Singh, "Lessons from China's Economic Reform," *Journal of Comparative Economics* 16 (1992): 201-25; and Peter Harold, "China's Reform Experience to Date," World Bank Discussion Paper, no. 180 (World Bank, Washington, D.C., September 1992).

7. Kang Chen, "The Failure of Recentralization in China: Interplays among Enterprises, Local Governments and the Center," in *Markets and Politics*, ed. Arye Hillman (Boston: Kluwer Academic, 1990).

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