

---

## 8. The complex task of evaluating China's economic reforms

---

Dwight H. Perkins

Scholars, practitioners and many others regularly comment on the pace of China's economic reforms, but there is no consensus on what constitutes slow or fast, partial or complete economic reform, either in China or in any other country. Economists often include in equations used to explain gross domestic product (GDP) growth a variable that purports to measure reform. Often this variable is based on surveys of 'informed individuals' or businesspeople, most of whom cannot possibly have the ability to make comparative judgements of more than two or three countries, if that. Total factor productivity (TFP) in growth equations is also sometimes used to measure whether or not economic reform is having an impact, but TFP is a residual that is high or low for a variety of possible reasons. Alternatively, many analysts of China's economy base their assessment of the pace of reform on reform in one or another sector that they think is critical to overall reform. The pace at which state-owned enterprises are made to face full domestic and international competition or the pace at which they are being privatised are often used. Others, particularly foreign observers, focus on financial reforms, ranging from the degree to which capital markets are open to the degree to which banks are managed and regulated according to practices widely used in high-income countries. None of these partial explanations comes close to capturing the complexity of fundamentally changing an economy from one kind of system to another.

In this chapter, I will attempt to outline the main components of economic reform in China and will give my views—where I have some basis for judgement—on the pace of reform in these components. First, however, one must define what one means by economic reform. In the context of China and in this chapter, economic reform is defined as elimination of the institutions of a command economy and replacement of them with the institutions of a modern market economy similar to those in most of the high-income countries of the world. It is assumed that this transformation has had and continues to have a positive impact on GDP growth. This definition, however, does not include all institutions and policies that impact the rate of GDP growth. Growth can be, and often is, affected by investment strategies or by the level of research and development expenditure, for example, but that would be as true in a command as a market economy.

There are five distinct types of institutions that are fundamental to a well-functioning market economy, all of which are substantially different from the institutions of a centrally planned command economy: 1) markets on which all or most goods and

services are bought and sold; 2) ownership and property rights that lead economic actors, particularly producers, to behave in a way consistent with the requirements of efficient markets; 3) legal and regulatory institutions that can protect property rights, solve disputes and correct for market failures in a way that is fair and efficient; 4) capital markets and a financial sector that are much like those found in high-income market economies; and 5) markets for labour and land that govern the allocation of these factor inputs and avoid major distortions such as those of the Chinese household registration (*hukou*) system. These five criteria are based on neoclassical economic theory. If the five criteria are carried out in rigorous accordance with this theory, the economic system will be efficient in the Pareto concept of efficiency. Most high-income market economies approximate these requirements to a substantial degree. China's experience in some of these five areas, however, differs from these criteria to a degree that raises the issue of whether the leadership of the country accepts all five criteria as a generally desired goal, even if the country deviates from them for practical political reasons. Or, whether instead China rejects some aspects of the five and substitutes something fundamentally different.

In what follows, we attempt to identify—within the limits of this author's knowledge—the degree to which China is implementing each of these five criteria in turn. In areas where the country—like all countries—falls short of the theoretical ideal, we ask whether this is because there are political barriers to overcome, because reform takes time or because China's socialist market economy with Chinese characteristics is substituting something fundamentally different.

## Creating markets for goods and services

China largely completed the transformation from a centrally planned administrative allocation of goods and services to market allocation at market-set prices in the 1980s and 1990s. In rural areas, this happened quickly in 1979 and the early 1980s, with the freeing up of rural markets where farmers could trade with each other and with outsiders coming in to purchase local products. Prices for major crops were controlled for a time and continue to be monitored, but largely reflect market demand and supply. Urban markets and prices, particularly for industrial inputs, took much longer to make this transition. The dual price system—under which centrally planned and allocated goods were sold at state-set prices and production above planned quotas was sold on the market—continued into the 1990s.

Resistance from powerful state-owned enterprises, among others, made moving at the outset to a one-price system politically impossible. By the mid-1990s, however, the dual price system had largely disappeared. This change resulted mainly from the actions of producer enterprises, not from central government action. Producer incentives were changed by encouraging them to make profits and by rewarding

them accordingly, and they preferred to sell their goods at the much higher market prices. Purchasing agents for user enterprises might prefer the lower state-set prices, but not if they found themselves facing long delays and shortages because of difficulty getting allocations at those prices. The replacement of the dual price system with a single price system was not the only area where reform in China proceeded from the grassroots up rather than from the central government down. The Communist Party of China (CPC) plenum of 1992 in essence recognised what was going on by redefining the ultimate goal as creating a 'socialist market economy'. Today, the government controls very few domestic prices, and most of the areas where such control does exist are in sectors where 'natural monopolies' lead most high-income countries to regulate prices.

The creation of markets and market prices in the 1980s and 1990s largely affected the allocation of domestically produced goods and services. The purchase and sale of imports and exports remained under central government control for longer. Initially, foreign trade was controlled by a few monopoly trading corporations, but, gradually, the number of organisations allowed to participate in international markets was expanded and producing enterprises could then buy inputs themselves and sell their output on the world market.

When China joined the World Trade Organization (WTO) in 2001 on terms that did not include the exceptions given to 'developing countries', China agreed, in principle at least, to allow its domestic markets to open to international goods at international prices (subject to some tariffs). There is an ongoing debate around the world about how faithfully China has implemented WTO rules and practices, and there are certainly some Chinese practices that involve subsidies to exports or restrictions on imports that are inconsistent with WTO rules, but any attempt to measure these distortions or to compare them with similar distortions in other East Asian or European economies is far beyond the scope of this short chapter. By any reasonable standard, Chinese goods and services are sold on markets at market prices that are broadly consistent with international prices for traded goods.

Enterprises in both the private and the public sectors face competition, although competition between public and private enterprises is often not on a level playing field. China's transition to a market economy in this area, therefore, is largely complete. It is not clear, however, whether the remaining unequal competition between some public and private enterprises is a desired outcome or simply an incomplete transition due to the political and personal interests of particular groups—something that exists in all countries. There is also in China still more government regulatory involvement in many markets than what is found in the most efficient market economies, but that is typical of many developing countries for a variety of reasons.

## Ownership and property rights

Most scholars regard private ownership and property rights as having played a critical role in the development of Europe and North America, and privatisation was a central part of many of the reform programs in Eastern Europe and Russia in their transition from command to market economies. A broad privatisation effort, however, has never been a central part of China's post-1978 economic reforms. The role of the state sector in China has nevertheless fallen steadily, to be replaced with a kind of private enterprise. At the outset of reform, this was evident mainly in the agricultural sector. By the early 1980s, most rural communes had been replaced with individual household farms. The state, however, continued to hold ownership of the land and it was made available to farmers through long-term leases. The rules governing land leasing have gradually changed over time and farmers are generally allowed to sublease their land to others if, for example, they are working mainly in urban jobs. Subleasing, however, is subject to various rules that change from one region to the next. We will return to this issue later.

At the beginning of the reform period, all industry, most commerce and all financial institutions were either state-owned or collectively owned. That began to change after 1984, but only slowly. Rural and urban smaller-scale collective industries remained as collectives well into the 1990s before most began to be privatised. Rural collective enterprises in the past did have a kind of property right, but it was based on the practice of respecting the land farmed by a given commune or brigade as in some sense belonging to that commune or brigade. Land could be taken for major projects by the central government, but land was not commonly transferred from one commune to another. Collective enterprises under a commune or brigade also in a sense belonged to the unit where they were located and that carried over to the townships and villages that replaced the communes and brigades. Smaller state-owned enterprises were also gradually privatised as market forces became steadily more dominant. Successive party congresses increased their formal recognition of private enterprises and a version of private property rights.

Most current industrial data apply to enterprises with sales above a certain size (RMB5 million through to 2010 and RMB20 million thereafter). Most industrial enterprises smaller than this were, for the most part, run privately. The ownership data for the larger enterprises are presented in Table 8.1, and are arranged grouping together types of ownership that are mainly state-owned, collectively owned or privately owned. There are private shareholding companies, but a majority of those listed on the Shanghai and Shenzhen stock exchanges have majority state ownership and are in effect state-owned enterprises. The collective form of ownership is largely disappearing for larger enterprises. Foreign-funded enterprises are mostly private and their share is rising more rapidly than any other sector, including domestic private industrial enterprise ownership. The major uncertainty about ownership is

with the category of limited liability companies (LLCs). Solely state-owned LLCs are listed separately, as are privately owned LLCs, but, then, what are the 'other' LLCs? They have average sales of RMB300 million, suggesting that many or even most may be independent of direct state control—but that is conjecture.

Table 8.1 Industrial enterprise revenue (RMB billion)

	2001	%	2015	%	2015/2001
	GVIO		GVIO		%
State enterprises	1,722.919		4,520.2		262.4
Shareholding	1,269.834		9,963.1		784.6
Sole state LLC	514.226		4,661.8		906.6
Joint	85.076		27.2		32.0
<b>Subtotal</b>	<b>3,592.055</b>	<b>37.6</b>	<b>1,9172.3</b>	<b>17.3</b>	<b>533.7</b>
Collective and cooperative	1,304.745	13.7	822.6	0.7	63.5
Private	876.089		38,639.5		441.0
Hong Kong, etc.	1,184.719		9,692.6		818.1
Foreign-funded	1,537.372		14,877.2		967.7
<b>Subtotal</b>	<b>3,598.180</b>	<b>37.5</b>	<b>63,209.3</b>	<b>57.0</b>	<b>1,756.7</b>
LLCs and other	1,049.716	11.0	27,781.1	25.0	2,646.5
<b>Total</b>	<b>9,544.696</b>	<b>100.0</b>	<b>110,985.3</b>	<b>100.0</b>	<b>1,162.8</b>

GVIO = gross value of industrial output.

Sources: NBS (2003: 459; 2016: Table 13.1).

Formal ownership in 2018 of the other urban and large-scale sectors of the economy varies considerably. The dominant enterprises in the banking sector are mostly state-owned, although there is some private and foreign ownership. Ownership in the insurance sector is somewhat murky, but there is clearly substantial state ownership in some major companies and all are highly regulated by the state. In commerce, state-owned enterprises control only 7 per cent of all sales, but LLCs, sole state-owned and other enterprises account for 43 per cent. The rest are mostly private. State-owned firms account for only 12 per cent of the gross value of construction activity in 2015 and only 10 per cent of the floor space under construction. In the transport sector, railroads are state-run, as are most (but not all) of the major airlines.

The 2013 third plenum reform list did not include a call for privatisation of state-controlled firms. It did suggest there could be an increase of 'mixed ownership', where private capital joined with public capital, but the main thrust of the reforms was to make both the state-controlled and the private-controlled sectors perform better by making them face market competition. In that context, enterprises with monopoly rights gained through government administrative directives would be eliminated, but this in no way implied that state-controlled enterprises would

become just like private firms. A key difference was that top management in all state-controlled enterprises is and will continue to be selected by the CPC's Organisation Department, not by public or private shareholders. The Organisation Department does make a serious effort to find competent people to place in top enterprise and government management positions, but loyalty to the party remains the essential characteristic of these appointments. Many in top management are more like senior civil servants than private entrepreneurs; their career is in the party and the party moves them from one position to another, both in producing enterprises and in government. They will stress enterprise profits if that is what the party wants, but most of the time the party has diverse goals, many of which are not typically found in the objectives of private enterprise management.

One should also not overstate the independence of private-sector management. The government and party have substantially more control over the actions of private enterprises than is the case in most high-income market economies in Europe, Japan and North America. Business decisions in China are subject to myriad government regulations and approval processes. Even small-scale enterprises often have close ties with local governments, without which many would have trouble surviving. Private firms—except very small ones—have their own party committees. Those committees are not supposed to be involved in management, but they do have a role in ensuring that the firm adheres to the broad objectives of the party, and management ignores those objectives at their peril. To make that clear, the CPC and the government, just prior to the nineteenth party congress in October 2017, issued a statement respecting private sector rights and promising a favourable market environment for them—but in return for private entrepreneur patriotism and acceptance of stronger party guidance (MERICS 2017).

The private sector is clearly playing a steadily increasing role in the country's economy in large part because private-sector firms consistently outperform state-controlled firms. That said, the nineteenth party congress and Chairman Xi Jinping's three-hour speech made it clear that China, today at least, has no intention of moving all the way to having an enterprise leadership for whom maximising profits is the overarching objective. The much wider range of objectives of the party leadership in Beijing and the party committees in the enterprises—both public and private—will continue to play an important and possibly dominant role. Throughout much of the world, state-run enterprises with multiple government-set objectives have generally proved to be substantially less productive than their private-sector counterparts, which are able to set their own goals (in contrast with private-sector firms that are highly regulated by governments).

Is there any evidence of whether party and government leadership in China is providing a more or less favourable climate for enterprises over time? One set of quantitative data we have on that score are the annual *Doing Business* surveys of the World Bank (Table 8.2).

Table 8.2 China: *Doing Business* overall ranking

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Overall ranking	93	83	83	89	79	91	91	96	90	84	78
Registering property	21	29	30	32	38	43	44	48	37	43	42
Resolving closing	75	57	62	65	68	75	82	78	54	55	53
Enforcing contracts	62	20	18	18	15	16	19	19	35	7	5
Minority interests	83	83	88	93	93	97	100	98	132	134	123
Trading across borders	38	43	48	44	50	60	68	74	98	96	96
Paying taxes	168	168	132	130	114	122	122	120	120	132	151
Getting credit	101	84	59	61	65	67	70	71	71	79	62

Sources: World Bank (various years).

As the data in Table 8.2 indicate, over the past decade, ‘enforcing contracts’—a critical issue for businesses both private and public—has become significantly better. For the most part, however, China ranks far below most of the more successful developing economies. China’s 2016 ranking at 78 puts it at a similar level as Turkey (69), South Africa (74) and Ukraine (80).

A better measure of whether the Chinese Government and the CPC’s leadership over enterprises has been positive or negative for the economy would be a sector-by-sector, public and private study of productivity gains over time compared with similar data for other market economies at a similar stage of development and with less government or political party leadership. That exercise is far beyond what is possible here.

## The legal system

Closely related to the property rights issue in judging China’s economic reforms is the status of the country’s legal system. In high-income countries in North America and Europe, the legal system is arguably the principal institution enforcing property rights. When either other individuals or the government threaten those rights, the property owner does not typically go to the highest government official as possible to ask for support. The individual or company threatened goes to court. In a similar vein, the parties to all manner of disputes—if they cannot resolve these disputes through direct discussions between the parties involved—may go to a mediator, but more often they go to court. The courts are the ones to apply and interpret the laws in economic or civil disputes. The judges who preside over these courts are highly

educated in the law and, while they are appointed by politicians in most cases, once appointed, they act independently of the government, including the people who appointed them.

China's legal system in the economic sphere falls far short of the standard of the stronger legal systems in the West. That said, China's legal system has come a long way from where it was at the beginning of the economic reform period in 1978. During the Cultural Revolution, the legal system was effectively dismantled and the law profession abolished. Beginning in 1978, the legal system had to be rebuilt from scratch and the economic laws on the books—written for a Soviet-type command economy—had to be completely rewritten for what was to become a market economy. The creation of a modern legal system in the economic sphere had also to deal with the historical experience of Chinese businesses that rarely went to the formal legal system to settle disputes. Disputes going back centuries were settled directly by the parties involved or in accordance with guild rules or the rules of other kinds of associations, not by the local government magistrate who had the authority to try formal legal cases. This practice even applied in places such as Hong Kong, where there was and is a judicial system modelled after that in England.

A modern market-oriented judicial system in the Chinese mainland did not spring up overnight in the 1980s. Even rudimentary market-oriented economic laws, such as laws on corporate taxes or contract disputes, did not really exist in the 1980s. The decision to make foreign investment in China legal early in the 1980s attracted mainly Hong Kong and other overseas Chinese businesses that were experienced with working in societies where security—including security from state predation—was handled by establishing personal ties with local authorities. By the 1990s, however, many of the formal laws required in a market economy were in place and a judicial system capable of implementing that legal framework had begun to be created. The quality of that legal system initially, however, was low. Judges had little or no training in the law and the number of trained lawyers was still very small for a nation with millions of businesses and a population of more than 1 billion. That situation changed steadily as more and more judges received legal training and the law profession and law schools became accepted as essential parts of a modern market economy, at least in the economic sphere. By the beginning of the twenty-first century, more and more individuals and businesses were going to the courts to settle disputes, particularly in the economic sphere. The data for the continued rapid expansion of court cases in the economic sphere and in the number of lawyers are presented in Table 8.3.



Table 8.3 Judicial system—quantitative indicators

	2002	2010	2015
<b>Cases accepted by courts</b>			
Contract disputes	2,266,695	3,222,555	6,013,386
Economic rights disputes	869,013	1,444,887	2,325,392
Administrative	80,728	136,353	220,398
Number of lawyers	136,684	195,170	297,175

Sources: NBS (2003: 836; 2011: Tables 23.9, 23.30, 23.31; 2016: Tables 24.18, 24.19, 24.20).

During the first part of the twenty-first century, court cases in the economic sphere rose at 8 per cent a year, starting from an already substantial level in 2002. Clearly, an increasing number of businesses and individuals concluded that the courts were a logical place to go to settle disputes—something that would not have been the case through much of Chinese history and certainly not during the 1960s and 1970s. But why, as indicated in Table 8.3, were there so many fewer cases in the administrative sphere? These cases mainly involved individuals and businesses going to court over government actions in the economic sphere. It is likely that people and companies did not go to court in such cases because there was only a very small chance of success.

Quantitative studies have come up with some answers as to where the legal system is most used to settle disputes. This evidence can in turn be used indirectly to provide evidence of the changing quality of the judicial system. To begin with, there are far more cases and more lawyers per capita in the more advanced provinces on China's coast than in central and western China (with a few exceptions). There are also more pressures from foreign-owned firms (which are mostly on the coast) for judicial reform than from Chinese-owned firms (including those in Hong Kong), both private and public. The latter rely more on personal relations with officials through entertainment and outright bribery than the former, and thus feel less need for protection through the legal system. The smaller number of administrative cases, as noted above, in part reflects the fact that courts tend to be biased in favour of the government in such cases. The legal system has also been designed in part to limit disputes that could become serious challenges to political stability—notably, for example, with respect to labour disputes that could turn violent. These and other problems, of course, also exist within the criminal law and legal system and in political cases, but the focus in this chapter is on the economic system.<sup>1</sup>

<sup>1</sup> For a much more in-depth discussion of these and related issues about the legal system, see Wang (2015), on which this short paragraph is largely based.

As in other areas, legal reform in China is progressing steadily but not through dramatic changes in the government's design or management of the system, rather through gradual professionalisation of the judiciary and legal fields. Progress is far greater in areas that are the most advanced in terms of other market-oriented reforms than in areas where state involvement in the economy is much greater and foreign investment is lower. Even in the most advanced areas, the legal system as it pertains to the economy has major biases and limitations. Put differently, there is no consideration of having a judiciary truly independent of the executive branch of the government. The role of the CPC—as defined both at the nineteenth party congress and on many previous occasions—makes clear that the long-term objective of legal reform does not include moving towards full judicial independence on the Western model. Nevertheless, the system is far more advanced towards a modern market-oriented legal system than was the case only one or two decades ago.

## Capital markets, financial reform and macroeconomic policy

The financial system in a market economy is fundamentally different from that in a command economy, in terms of both structure and the main goals of the system. In a command economy, the financial sector's main role is as a backup to help implement plan targets. It also takes deposits from individuals and makes loans, but the loans are nearly automatic if required by the plan and are mainly for working capital, not investment. Investment decisions in China were made by central, provincial and local planners and much of the financing came directly from the government budget. The financial system in a market economy, in contrast, is central to the operation and performance of the system, as it mobilises the savings of millions and loans that money to investors. Getting the design and implementation of the financial system wrong in a market economy can lead to recessions, inflation, balance of payments crises and/or secular stagnation. There is, however, ongoing debate even in high-income countries about just how the financial system should be designed and managed. Failures—mainly in the financial systems and macroeconomic policies of several Asian countries—were responsible for the sharp recessions in many developing countries in 1997–98. Even more serious failures of the financial system in high-income countries, particularly the United States, caused the severe world recession of 2007–09.

In a sense, China in the early 1980s created a modern market-oriented financial system almost overnight, when the Soviet-style mono-bank system was abolished and replaced with four state-owned commercial banks and a central bank, the People's Bank of China (PBC). But that system continued to operate in key respects much like the old mono-banking system. When state-owned enterprises needed

money, the commercial banks provided it to them whether or not they were credit-worthy. Savers could either hoard cash at home or put their money in one of these commercial banks and receive a modest rate of interest. Interest rates were fixed by government fiat for both savers and borrowers and done in a way to ensure the banks made a profit. This situation continued well into the 1990s. One result was periodic bouts of inflation as demand for investment funds by the state sector surged and the banks would accommodate and the money supply would rise. High-level authorities ended inflationary bouts by giving administrative orders to the banks to cut their lending.

The head of the central bank—similarly to the pre-reform command economy period—was little more than a civil servant carrying out the orders of higher-level authorities until then deputy prime minister Zhu Rongji was made head of the PBC in the early 1990s, with authority to wring inflation out of the system. The result of that change was a peaking in 1995 of the consumer price index, followed by a fall in the rate of price increases to the low single digits, where it has remained since (consumer prices rose by an average of 1.8 per cent per annum from the end of 1997 through to 2017). The methods for reining in inflation, however, were initially similar in some respects to those of the past: the banks were given lending quotas and those quotas were enforced. But, increasingly, the emphasis on lending quotas gave way to indirect controls over lending.

There was also a major problem by the 1990s of nonperforming loans in the banking system. Officially, in the mid-1990s, nonperforming loans constituted 25 per cent of the total assets of the banking system and, unofficially, many observers believe the true figure was much higher. An elaborate system of asset management companies was created to take over the nonperforming loans and the banks were made solvent by simply paying these companies the full value of the loans. In effect, the central bank printed the money and gave it to the banks.

By the late 1990s, the banking system had begun a process of changing the behaviour of those running the banks to make them behave more like commercial banks in a high-income market economy. Gradually, the banks began to make loans to private-sector enterprises and mortgages to consumers. They began to pursue profits and to establish systems for properly appraising the credit-worthiness of their borrowers. New credit instruments such as personal credit cards were introduced, along with a wide variety of modern banking practices from abroad. Many new smaller banks were founded and government policy banks were established as one of several steps to remove politics from bank lending. Modernising the banking system in China has been an ongoing process, not a one-stop radical reform. The process continues to this day, and astute participants in the system compare practices favourably with those in other market-oriented banking systems.<sup>2</sup> The dominant banks, it should

2 For a systematic micro-look at recent reform efforts in the banking system, see Stent (2016).

be noted, remain state enterprises and there is no plan to privatise them. The Organisation Department of the CPC selects the top managers and the banks still take into account the leadership of the party in their decisions. Wringing politics out of the system has meant efforts to get rid of local political interests in bank decision-making, not getting rid of national or central party political interests.

The Shanghai and Shenzhen stock exchanges were formally started in 1990, but in the 1990s were mainly vehicles for selling shares of state-owned enterprises to private interests. Over time, the stock exchanges have listed more and more firms, including private ones. The China Securities Regulatory Commission (CSRC) regulates the stock market. Its regulations—like those of the China Banking Regulatory Commission (CBRC)—are similar to those of high-income market economies. Having modern regulations adjusted for local conditions is one thing; enforcing them is another. This is the case for stock markets around the world, but particularly in developing countries, and China has a long way to go before predatory practices such as insider trading are reduced to an acceptable level. This is partly a learning process for the regulators, but it is also a learning process for the population at large, which participates in the market. That is still an ongoing process in the United States, and only the Hong Kong exchange comes close to reaching America's far from perfect level.

Furthermore, even in the United States and Europe, once one gets beyond such issues as preventing insider trading, the precise nature and amount of regulation required are fiercely debated and there is no consensus on an ideal middle ground. China today (2018) is still at the highly regulated end of this debate, largely because of ongoing direct state ownership of the largest financial enterprises. Given that China avoided the major recessions of 1997–98 and 2007–09, it has experienced only a few periods where there were balance of payments concerns but no major crises<sup>3</sup> and inflation has been negligible for the past two decades, it is hard to argue that China has the regulatory balance wrong. However, as one looks at some of the financial problems that have arisen in the past one or two decades and others that might arise, such a conclusion about China's design and regulation of the financial system is premature.

The problems of financial reform that have been the focus of attention in recent years are those created largely by incomplete market reform in the banks and partly by central government initiatives that were financed in ways that were not sustainable. These include the rapid expansion of 'shadow banking' and the increasing burden of local government debt. There is also a more general issue of whether China's

---

3 There were concerns, for example, that external influences from the East Asian Financial Crisis of 1997–98 might impact exchange rate policy negatively, and there was a sharp drop in foreign exchange reserves in 2015 and 2016, but nothing that required China to rein in growth.

periodic bailouts of nonperforming loans in the system have created a serious level of moral hazard that could lead to slower growth in the future than otherwise would have been the case.

The term shadow banking refers to a range of informal financial vehicles—often called wealth management products—the principal purpose of which is to attract savings funds that were seeking higher returns than could be achieved at the low state-fixed interest rates on deposits paid by the banking system. The commercial banks themselves initiated many of these products, but they were recorded separately from the banks' formal balance sheets and were unregulated by the CBRC. The central bank dealt with this in part by abolishing the state-set ceiling on deposit rates in 2015. In 2017, however, market interest rates in China as well as around the world remained very low, so wealth management products remained attractive. The solution was to regulate shadow banking, and that process was under way by 2017, but was only in the beginning stages. There are observers who suggest that shadow banking, given its large and growing size, could lead to a major financial crisis. That, however, seems unlikely given that virtually all of the money is lent and borrowed by domestic individuals and institutions and the government has always been both able and willing to bail out nonperforming assets of this kind in the past. The danger from continuing bailouts, if they become necessary, is less a financial crisis and more the possibility of increasingly risky and poor decision-making by lenders leading to slower long-term growth.

The local government debt problem similarly resulted from macroeconomic decisions by the central government. The central government, in a successful effort to avoid the 2007–09 world recession, instituted a large economic stimulus; however, less than one-quarter of the financing of that stimulus and other similar efforts later was provided by the central government itself. Instead, it instructed local governments to finance an even larger share, although all but the richest local governments lacked sufficient tax revenue to cover financing costs directly. Local governments—subject to restrictions on their ability to borrow—nevertheless were able to indirectly create financial vehicles to cover their investment obligations. The result was a steady rise in local government debt. Eventually, the total local government debt reached RMB24 trillion, at the end of 2014. The central government had to rescue many local governments from bankruptcy, turning RMB8 trillion of that debt into government bonds.

The local debt issue also illustrates how the central government since the third plenum of 2013 has begun to address shortcomings in its management of fiscal policy. One of the principal problems of the local government debt was that the central government had little knowledge of how fast that debt was rising. Only a few (three or four) people in the understaffed Ministry of Finance were responsible for overseeing this debt, local government records were minimal and reporting to the centre was often nonexistent. It took a special central government audit to get

the 2014 figure. At the same time, the government passed a revised budget law that required local governments to keep detailed budget documents and to make those documents available online as well as to the Ministry of Finance. The revised budget law has now been implemented and local budgets are available online. That said, proper and accurate implementation of the revised budget law will require large numbers of financial officers with relevant training—probably in the tens of thousands—in local government and their affiliated organisations. It is unlikely the required numbers of financially skilled personnel are available as of 2018, but the change is nevertheless real.<sup>4</sup>

Another area of finance where reform has progressed is in the opening of the country's capital markets so that capital can to some degree move in and out of the country with increasing ease. Many of the controls over these capital flows, however, remain on the books and they were used to restrict openness in 2015 and early 2016 when capital outflows led foreign exchange reserves to fall by more than US\$700 billion in less than a year, before levelling off later in 2016. That experience suggests that, at China's current stage of development, complete market-friendly reform should probably not include full opening of its capital markets. It may be in the interests of financial institutions in high-income countries for China to fully open its capital markets, but it is not in China's interests to have to deal with rapid short-term inflows and outflows of hundreds of billions of dollars on a monthly or daily basis. China needs time to reach a more long-term stable equilibrium in its international capital markets before lifting capital controls entirely. At a minimum, any prudent manager of the economy would want to have such tools in reserve for emergencies.

The issue of open capital markets illustrates another consideration that needs to be taken into account in assessing the state of financial reform in China: not all financial innovations in recent years in high-income countries have had a positive impact on those economies, as 2007–09 made clear. Even some of the innovations that were positive in high-income countries could easily prove to have negative consequences for a country at China's current state of development.

Financial reform is a complex topic, but there is no doubt that China has made major progress in creating a modern financial system suitable for a market economy. Some of the older financial institutions such as the banks are now quite sophisticated, while new institutions such as insurance companies and the stock exchanges are far short of where they need to be.

Progressing to an efficient financial system will take time, but, in most respects, the direction is clear and substantial progress has been made. One change that would make the financial systems of China more like those in most high-income

---

<sup>4</sup> This discussion of local government debt is based mainly on work by Christine Wong. See, for example, Wong (2017).

countries, however, is not going to occur. The Chinese Government and the CPC and its Organisation Department are not going to substantially reduce their role in controlling and directing that system. High-income market economies generally remove government from direct control over the sector, relying in part on setting a regulatory framework designed to limit predatory behaviour and managing the sector mainly through the indirect controls of monetary and fiscal policy. China has, at least for the near future, decided to stop short of that goal.

## Labour markets, land markets and rural–urban migration

In the pre-reform era, land and labour markets did not exist. Land was owned by the state ('by the whole people') and urban land use was allocated to units by the government and could be taken away by the government. In rural areas, use rights for land were held by rural communes, brigades and production teams, but not by households. The government could take away land use rights but generally did so only for major infrastructure projects, such as a dam that flooded farmland. Central planners also allocated urban skilled labour and the hiring of unskilled or semi-skilled workers was administratively distributed to individual enterprises by urban labour departments. Rural labourers, for the most part, stayed in the commune, brigade and team into which they had been born or married. Rural to urban migration was tightly controlled by a variety of mechanisms and these controls were largely responsible for China having an unusually low rate of urbanisation prior to 1978. One positive benefit of these controls was that women registered as urban residents became a much larger component of urban employment than in the past. This benefit disappeared, however, when migration from rural areas was no longer restricted; the share of women in the urban labour force fell substantially.<sup>5</sup>

The rapid development of industry after 1978 caused urban labour shortages that were initially dealt with in part by urban enterprises contracting with rural enterprises to produce key inputs. This approach, however, began to quickly give way in the 1980s to allowing increasing amounts of rural labour to migrate to urban jobs either through the labour bureaus or directly to the enterprises. The system of administrative allocation of skilled personnel gradually gave way to a system where urban skilled labour could change jobs and enterprises with increasing freedom. By the twenty-first century, China had a market-based labour system in its urban areas.

<sup>5</sup> From 1965 to 1978, the number of women workers and staff in state-owned enterprises (all enterprises were either state or collectively owned) grew from 7.86 million to 21.26 million (NBS various years) and kept on rising in the 1980s and early 1990s (in all urban units), peaking at 58.9 million in 1995, before beginning to decline after 1997, to only 41.6 million in 2002 (NBS 2003: 139).

Urban land use changed in 1990 to a system whereby enterprises could lease (but not ‘own’) land for up to 70 years. This approach was often encumbered by the need of the enterprise to find alternative housing for those already on the land, for example, but that gave way to urban governments mostly leasing land at market prices. The privatisation of housing began slowly in the early 1990s, but became nationwide policy by the end of that decade. Housing that had been allocated by enterprises to their employees was sold to the employees at highly discounted prices and a private market for new housing was created. After the initial privatisation, virtually all urban housing is either leased or rented to households at market prices. The rapid expansion of private housing in turn led the banking system to make mortgages an increasing, and now quite large, portion of their loan portfolios.

Two major related distortions remain as of 2018—one in the labour market and the other with respect to rural land. The major labour market distortion is the *hukou* system that divides the population into rural and urban residents and makes it difficult to switch registration from rural to urban. Since much schooling and a variety of health and other welfare and insurance programs in urban areas are available only to registered urban residents, this has a major impact on the welfare of urban workers and their families who are registered as rural residents. There is an efficiency, as well as a welfare, loss from this practice. Children of migrants are often left behind with their grandparents in the villages, where they receive an education inferior to that of their urban counterparts. They also learn little about how to cope with urban life even though once they attain working age they will spend most of their life in cities.

Compounding this situation is the fact rural land use rights can sometimes be taken away if migrants succeed in changing to urban registration status. Migrant leasing of land use rights to others is allowed and restrictions on the practice have gradually been removed, but the system still falls well short of an unfettered market system. The announcement following the nineteenth party congress that rural land rights, including the right to lease land, would be strengthened could correct some of the imperfections in the system. Another major distortion that remains is the classification of land into arable land for agricultural use and land that can be used for local enterprises and buildings of various sorts. The price of the latter kind of land is much higher than that of agricultural land, but only local officials have the ability—legally or otherwise—to change land from one classification to the other. Among other problems, this is a major source of local corruption and related rural disputes.

The *hukou* system is widely criticised in China and it is gradually being phased out, particularly in cities where there is an effort to attract more migrants to fill local enterprise labour requirements. The system, however, is still very much in place in many other cities, including those like Beijing and Shanghai that have the highest incomes and the most job opportunities.



## Conclusion

Clearly, China has made substantial progress over the past four decades in creating an economy governed increasingly by market forces. Progress on this score began slowly in the 1980s in large part because the objective of the leadership and most of the reformers in the early stages saw the market as one of several instruments—not the main instrument—for creating a better performing economic system. That changed by the mid-1990s to a consensus to create a socialist market economy, but much of the progress towards that goal came from actions starting at the bottom and working their way up to the leadership rather than from top-down government and party-led reforms. Both the gradual replacement of the two-price system with a one-price system and the rapid development of township and village enterprises reflected this bottom-up reform effort. Government control of this burgeoning market system was still often exercised through administrative controls rather than indirect market forces, particularly in the financial sphere.

By the late 1990s and at the beginning of the twenty-first century, however, market forces largely governed China's economy. Most goods and services were distributed at competitive market prices. Urban housing and land were increasingly governed by market forces, as were the urban labour market and rural to urban migration. Large distortions, however, remained in the rural areas, particularly with respect to land and, because of the *hukou* system, to labour. Elsewhere, the institutions of a modern market economy were steadily strengthening. That was true of the respect for property rights—in particular, private property rights—but also in the gradual strengthening of the legal system. At the national level, the central bank became more like a central bank in a high-income country and the financial institutions beyond the banks grew rapidly and became stronger. In some areas, such as the stock market, however, the financial system still falls far short of the high-income market economy standard. That is even more the case for the legal system as it applies to the economy. China today also retains many controls over capital flows in and out of the country. The reasons for the retention of these controls reflect the fact that the financial system—despite all of its technical sophistication—still has not settled into a stable equilibrium where such controls would not be needed.

The main area where the Chinese market economy differs in a major way from most high-income market economies is in the role of the government and the CPC. Government regulatory involvement in the economy is far greater than in most high-income market economies, and direct state ownership of controlling interests in the economy is also more pervasive. Perhaps of even greater significance, however, is the central role of the CPC and its Organisation Department in both selecting the personnel in the system—including in many of the enterprises—and strongly influencing the behaviour and objectives of those parts of the modern urban

economy that it does not directly control. The nineteenth party congress made clear that that role for the party is not going to change and is, if anything, going to be strengthened.

That level of party involvement virtually guarantees that politics and other non-economic objectives will play a larger role in economic decision-making even at the micro level than is normally the case in high-income market economies. It is not that party and state influence by definition requires economic decision-makers to deviate from the market efficiency requirement that they maximise profits or, more realistically, that they not deviate from that goal more than in most relatively efficient market economies. Nearly a century ago, Abba Lerner (1944) and Oskar Lange (1936) demonstrated that enterprise management in socialist economies with widespread state ownership could simply order management to maximise profits. They could thereby achieve a closer approximation of what an efficient market required than was found in the actual behaviour of management in capitalist market economies. Few if anyone today, however, believes that state ownership and political party influence would in fact emphasise profit maximisation to the exclusion of other political and social objectives. The nineteenth party congress confirmed that the CPC's political goals will continue to play a major role in enterprises, both those directly owned or controlled by the state and those that are private.

What is less clear is how this greater role for politics in economic and enterprise decisions will affect the performance of the economy. The 2012–17 slowdown in economic growth and the falling rate of TFP growth could be due in part to this large role for politics.<sup>6</sup> A number of studies have shown that the productivity of state-owned enterprises is lower than that of the private sector. Many countries have attempted to make state-owned enterprises as efficient as those that are privately owned, usually with only limited success. The overall slowdown of China's GDP growth and TFP, however, can be explained in part by actions having little to do with whether or not the market is functioning well. All countries that have to date reached high–middle-income status have experienced a decline in their GDP growth rate. In China, in addition, the continued emphasis on infrastructure investment despite declining returns in that sector is another example, although the continued emphasis on infrastructure could also be considered the result of politics (Gatley 2018).

We do not yet, therefore, have a measure that can provide us with a quantitative assessment of the degree to which China has created an efficient market economy. Given the complex nature of moving from a centrally planned command economic system to a market economy, a simple economic measure of progress from one

---

6 My own estimates based on the methodology in my earlier essay with Thomas Rawski suggest that TFP has fallen from an average rate of 3 per cent per annum in 2006–11 to 1 per cent per annum in 2012–16 (Perkins and Rawski 2006: 829–86).

system to the other may not be possible.<sup>7</sup> What this chapter has argued is that attempts to measure this progress by looking at one or another element of the process, such as financial reform or the number of state-owned enterprises, are not the answer. One must assess the complete complex picture, even if that requires qualitative judgement and/or multiple quantitative assessments.

## References

- Gatley, T. (2018), The working capital heist, *Gavekal Dragonomics*, 9 January.
- Lange, O. (1936), On the economic theory of socialism, *The Review of Economic Studies* 4(1): 53–71.
- Lerner, A. (1944), *The Economics of Control: Principles of Welfare Economics*, New York: MacMillan.
- Mercator Institute for China Studies (MERICS) (2017), *China update: Loyalty to the party becomes top duty of private entrepreneurs*, 12 October, Berlin: MERICS.
- National Bureau of Statistics (NBS) (various years), *China Labour Wage Statistics*, Beijing: China Statistics Press.
- National Bureau of Statistics (NBS) (2003), *China Statistical Yearbook*, Beijing: China Statistics Press.
- National Bureau of Statistics (NBS) (2011), *China Statistical Yearbook*, Beijing: China Statistics Press.
- National Bureau of Statistics (NBS) (2016), *China Statistical Yearbook*, Beijing: China Statistics Press.
- Perkins, D. H. and Rawski, T. G. (2006), Forecasting China's economic growth to 2025, in L. Brandt and T. Rawski (eds), *China's Great Transformation*, Cambridge: Cambridge University Press.
- Stent, J. (2016), *China's Banking Transformation*, Oxford: Oxford University Press.
- Wang, Y. (2015), *Tying the Autocrat's Hands: The rise of the rule of law in China*, Cambridge: Cambridge University Press. doi.org/10.1017/CBO9781107785342.

---

<sup>7</sup> The Kornai Index developed by Janos Kornai, which compares the ratio of input inventories with output inventories, measures in a single figure the degree to which a country has adopted a centrally planned command system; but we need a measure that captures the difference between two market systems that differ primarily in the degree of political involvement in the economy.

Wong, C. (2017), Rumbling of reform in China's fiscal foundations, *East Asia Forum*, 17 April. Available from: [www.eastasiaforum.org/2017/04/17/rumbling-of-reform-in-chinas-fiscal-foundations/](http://www.eastasiaforum.org/2017/04/17/rumbling-of-reform-in-chinas-fiscal-foundations/).

World Bank (various years), *Doing Business*, Washington, DC: The World Bank. Available from: [www.doingbusiness/reports/](http://www.doingbusiness/reports/).

This text is taken from *China's 40 Years of Reform and Development: 1978–2018*,  
edited by Ross Garnaut, Ligang Song and Cai Fang, published 2018 by  
ANU Press, The Australian National University, Canberra, Australia.

[doi.org/10.22459/CYRD.07.2018.08](https://doi.org/10.22459/CYRD.07.2018.08)