



## Thirty Years of Chinese Reform

# --- Transition from Planned Economy to Market Economy

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#### Abstract

The traditional Chinese planned economic system was formed during the first several years of the founding of PRC. Under this system, all sorts of behaviors by individuals, economic organizations and administrative organizations for their interests restrained vigor of the economy. Cost of this system was extremely high, but its efficiency was rather low. Reform started in the late 1970s has taken on features of gradual progress. The period before 1992 was the double-system stage, and afterwards has been the overall market economy stage. At present, framework of Chinese market economic system has taken its initial step, but its reform is not thorough. Several inertia factors and thinking methods in the traditional system still have impact on distribution of economic resources, and on behaviors of individuals, enterprises, and government, especially state-owned enterprises and departments.

Keywords: Planned economy, Market economy, Economic system

Chinese economy system (including basic economic instructure and economic operating mechanism) has undergone two major development stages since 1949 when the People's Republic of China was founded. The first stage was from the founding of PRC to the Third Plenary Session of the 11th Central Committee of the Communist Party of China, which was the establishment period of the socialist basic economy system and prevailing period of highly concentrated planned economic system. The second stage was from the Third Plenary Session of the 11th Central Committee of the Communist Party of China up until now, which is the perfection period of socialist basic economy system and gradual establishment period of socialist market economic system.

At the early beginning of the first stage, namely, from the year 1949 to 1956, firstly, New Democracy economy system was established within the entire country (by means of taking over assets of foreigners in China, confiscating bureaucrat enterprises to be owned by the country, and accomplishing reform of land system). Then from the end of 1952, a comprehensive socialist reconstruction was made on individual agriculture, handicraft industry, and capitalism industry and commerce. By the year 1956, the three great reconstructions had been basically finished, and public ownership system under socialist of production materials had predominated in the national economy.

In terms of national economy management system, high concentration and unity was implemented at the beginning of the foundation of the country. In March 1950, administration council of the central people's government issued "Decision on Unifying National Financing Economy", whose major content includes: unifying national financing income and expenses, unifying national material distribution, and unifying national cash management. This was one of the most important measures taken in terms of economy management after the foundation of PRC, which laid foundations for Chinese financing economy management system. The highly concentrated planned economic system was taken into form under the then background with the unification of national financing economy, with the implementation of the first five-year plan, with the socialist reconstruction and with expansion of large-scale economic construction. Although this kind of system had been affected largely by "Soviet Russia Mode", it was not copied completely. Some elements were originally created in combination with the Chinese situation. Especially in the beginning, there was some flexibility in the application of market factors. However, after the completion of socialist reconstruction, under the circumstance in which public economy predominated, a centralized planned system came into being with authority centralized, and administrative command organizing economic activities.

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About major disadvantages of this system, "Decision on Reform of Economy System by the CPC Central Committee" passed in the Third Plenary Session of the Twelfth Central Committee of PRC in 1984 had the following generalizations: "administrative and enterprise functions were not separated, with barriers between different departments and regions. The nation had too much and rigid control over enterprises, and ignored significance of commodity production, law of value and the market. Equalitarianism was serious during distribution." Of course, this was just recognition at the beginning of the reform. By 1990s, humans further realized the fatal drawback of the traditional system was ambiguous property right, in which there existed connatural disadvantages in the micro-enterprise system as the basis of economic system. Furthermore, such issues as unsound legal systems were all significant features of the traditional system.

An analysis from the perspective of system performance may reveal disadvantages of the traditional planned economical system in several aspects.

#### 1. Enterprise behavior

According to modern economics, enterprise is an organization with the purpose of benefits. An enterprise has all necessary power for production, operation and distribution based on property rights. Superiors of an enterprise should on complete behalf of its interests, while under the traditional system, an enterprise was merely subordinate of administrative organs. It was more like a production workshop inside an enterprise, and the entire society was a huge enterprise. Principal of an enterprise was like a workshop director, monitor or group leader. An enterprise should have to accept command of an administrative organ, comply with all its commands, and have no independent investment decision-making right. Task of an enterprise was to finish planned production assignment by its superiors. Because an enterprise under the traditional system was not one in its real meaning, principals of the enterprise were nothing more than officials of a certain rank (indicated by paths of their appointment, promotion, awarding and punishment, etc.). Under this system, an enterprise need not take any responsibility for its behaviors, since its benefits or loss would not have any impact on the enterprise and its principals, and bankruptcy would not happen, neither. Therefore, an enterprise didn't have any innovative motive, with extremely high operation cost and serious waste of resources.

#### 2. Individual behavior of laborers

According to hypothesis on human economic behavior in economics, each laborer (even each individual in participation of economic activities) intendeds to obtain maximum economic income with minimum labor paid, which is the internal tendency of laborers under the traditional planned system. In the environment of collective labor, laborers could not dominate capital property rights of their personal labor force, and domination of their labor force rested with the country or a collective organization. Although distribution according to work was executed nominally, it could not be realized due to complex calculation of personal labor. Therefore, equalitarianism and the big pot were inevitable. Under the thinking mode in which "Plan" penetrated into each aspect of economic activities, a unified salary standard (with age and official rank being primary parameters) by the nation seemed to be a necessary choice. Although in the situation in which effective supervision and calculation on labor per se, stimulation measures of super economy (typical of propaganda of master s spirit, selfless dedication spirit and political honor, etc.) revealed their validity during a certain period, they would finally appear impotent under the influence of the strong "economic man assumption".

## 3. Behavior of the government and its service officials

In a society, its complicated economic running system can be supported or maintained mainly by means of two relations: one property relation as discovered in the typical market economy country and another hierarchical relation confirmed by political status or identity. This is similar to the situation in the countries which implement highly planned system analyzed, (such as ancient India and some European countries in the Middle ages). The economic organization system before the Chinese reform was the representative of the latter, which was defined by Li Yiping as "a typical super administrative section".

"In traditional system, ownership was equalized to property rights, in which property right form under public ownership was not studied to support its running, but administrative section setting was studied to define positions and rights, and to communicate instructions for supporting economic running. Therefore, a position was not only defining of rights, but of interests. In addition to material benefits, political honors were also taken into consideration, also including satisfaction of realization of self-value, etc,." "Those in administrative positions of all ranks were principals of all levels in super administrative sections". "The traditional theory usually assumed that they were selfless, altruistic and served people whole-heartedly. Actual analysis would prove that, the fact was just as what Buchanan pointed out profoundly that, 'there were no difference between their behaviors and those of others studied by economists'".

To protect vested interests (positions and corresponding rights and remuneration) and to strive for higher positions was the motive of principals of administrative sections of all ranks (namely, government officials of all ranks, including all ranks of administrative personnel in an enterprise). Since appointment and removal was mainly determined by superiors, subordinates often had to be at their beck and call. Principals of an enterprise would rather breach economic rules, waste resources and increase costs than violate intention of superiors to make economic decisions. The fact that they held back

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unpleasant information, craved for glory, issued confused orders, suppressed subordinates and creative spirit of grass root laborers then followed a rational line. In such a background, creativity and scientific spirit of all ranks of economic administrative sections, officials and enterprise principals were inhibited. And together with interruption of such noneconomic factors as political activities, it would be certain that efficiency and benefits of the entire economic mechanism were low. Although some people might do their utmost subjectively or objectively for the society out of political enthusiasm, they were not able to change the negative impacts of the entire system.

Anyhow, under the traditional highly concentrated planned economic system, all sorts of behaviors by individuals, economic organizations and administrative organizations for their interests restrained vigor of the economy. Cost (Organizational cost of economic activities. For the moment, we do not use the concept of dealing cost, which should be a concept under the economic system of free market) of the system was extremely high and efficiency of the system was extremely low, which was exactly the impetus for reform.

From the Eighth Congress of the CCP to the Third Plenary Session of the 11th Central Committee of the Communist Party of China, in the process of its formation and development, disadvantages of the highly concentrated planned economic system took on continually, which aroused attention of the central government. Therefore, the government had tried several times to improve the situation, such as: power decentralization for several times, market adjustment on production and circulation of agricultural byproducts for a certain period of time, focus on economic legislation and supervision for a time, and attempt to open companies, etc., However, all these reform measures were merely confined to adjust central, local and segmented administrative management, or to activate circulation of consumer goods. They didn't refer to core elements of economic system, such as resource distribution means and property rights, etc., Meanwhile, rigidness of the theory caused these confined reform measures to be given up halfway, and led to a state of inconstancy.

Since 1978 when the Third Plenary Session of the 11th Central Committee of the Communist Party of China was held, under the drive of rural economic system reform, the entire economic system reform centered with reform on cities was gradually unfolded. From 1978 to the year 1992 was the first stage of reform, namely, reform stage of bipartite system. The period from 1992 up until now is the second stage, namely, reform stage of comprehensive marketization. Thereby, it is observed that, system transition from planned economy to market economy takes on obvious gradualness.

From 1978 to 1992 when was the period of bipartite system, the overall economic system was coexistence of planned economic mechanism and market economic mechanism, which played their role respectively in different fields, different areas and to different extent.

Reform of state-owned enterprises remained central aspect of reform on Chinese economic system. For this, all forms of explorations and attempts have been conducted, such as granting power to enterprises and allowing them to keep more profits, shifting from profit-sharing to tax-levying, responsibility system of contracted business or leasing system. Through the reform, operational mechanism of state-owned enterprises begin to change, changes took place to relations between administrative government and enterprises and enterprise vitality was aggrandized. However, many practices of traditional planned economic system are retained, so distribution of important resources and determination of price are still as in the traditional mechanism. For instance, primary essential factors of production still have to satisfy needs of state-owned enterprises, then is possible the entrance into the market of production means. "In the process of fund distribution, state-owned enterprises have the priority, the probability of their obtaining the capital is relatively high, the system cost of their use of the capital is relatively low, and the total cost of their use of the capital is lower than the market cost, so they still maintain the capital intensive technical structure which has a higher cost and which is inconsistent with Chinese resource endowment structure". Thereby, quite a good many unsatisfactory consequences are resulted, such as irrational industrial structure, serious loss of an enterprise, bad relationships between administrative sections and enterprises, and substantive dealings of power and money, etc,.

As for the majority of non-state-owned enterprises, because they didn't get policy support from the country in terms of capital and other resources, they had no choice but to seek for a way out in the market. Due to advantages of their property rights and mechanism, their pursuit of interests was much stronger, so they outperformed state-owned enterprises in terms of cost control, and labor productivity, etc, and their economic profits were far higher than those of state-owned enterprises. Besides, with more and more abundant rural labor forces seeking for employment in the city, sufficient and low cost labor forces were provided to private non-state-owned enterprises. Non-state-owned enterprises with flexible employment mechanism then turned to be main force for absorbing rural abundant labor forces. For them, market mechanism played a leading role in their production resource distribution. Lots of labor-intensive enterprises had the advantage of low cost, which exactly conformed to Chinese resource endowment structure, namely, abundant but low cost labor force and rare but valuable fund and capital. "In this sense, differences of systems are not only fundamental reason for technical selection differences between non-state-owned enterprises and state-owned enterprises, but internal cause for much more competition and more rapid development of non-state-owned enterprises.

During the period of bipartite system reform, the overall change situation was that, elements of planned economic

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system were gradually reduced, role of resource distribution by the market mechanism was gradually enlarged. Especially during the period from the end 1980s to the early 1990s when comparative advantages of state-owned enterprises were obviously revealed, decision-making section of the central government decided to transit from bipartite system to the market economic system.

Starting from 1992 when the era giant Deng Xiaoping held the important talks and when the Fourteenth Congress of CCP was held, reform of China entered a new stage. In the congress, it was clearly put forward that, the target of economic reform was to establish socialist market economic system. In 1993, the Third Plenary Session of the 14th Central Committee of the Communist Party of China passed "Decision on Several Issues in the Establishment of Socialist Market Economic System by the Central Committee of the CCP", which said that, "Establishment of Socialist Market Economic System is to enable the market to play a fundamental role in resource distribution under the national macro-control." It also sketched out the basic framework of Socialist Market Economic System, namely, to adhere to the strategy taking public ownership as the main body, and the strategy in which multiple economic sectors develop together; to further transform operational mechanism of state-owned enterprises; to establish a modern enterprise system required by the market economy, in which property rights are clear, rights and responsibilities are definite, administration and enterprises are separated, and management is scientific; to set up a market system which is open to the whole nation; to realize close combination of city and rural markets; to link up domestic market and oversea market so as to promote optimized distribution of resources; to transform functions of government control on the economy, and to set up a perfect macro-control system dominated with indirect means so as to ensure healthy running of national economy; to set up an income distribution system in which distribution by labor is the subject, efficiency first and fairness second; to encourage earlier better off of some areas and people, so as to keep to the road of richness for all; to establish a social guarantee system of multi-levels, so as to provide for city and rural citizens with social guarantee consistent with our national situation, and to accelerate economic development and social stability.

Considering prominent problems under the bipartite system, key points of the reform in the new stage are as follows: firstly, reform on property right system of state-owned enterprises, which is to establish modern enterprise system, optimize capital structure, industrial structure and strategic pattern of state-owned enterprises, and to shape micro-basis for the market economic system. Secondly, reform on financing and financial system, especially on investment and financing system, which is to establish investment mechanism by legal persons and obligation mechanism of bank credit. The key point is the establishment of risk obligations in investment and credit and improvement of investment benefits by means of commercial reform on state-owned financial enterprises. In other words, the originally plan-oriented fund and capital running mechanism should be transformed into the market-oriented mechanism.

In reform practice, the government adopted the strategy of "grasping the large and neglecting the small", which enabled large-scale state-owned enterprises to obtain more financial and financing support. Such strategic adjustments as capital reconstruction, bankruptcy, and merger were basically conducted under instruction of the government. Afterwards, capital scope of large-scale key state-owned enterprises got expanded, their structures got further optimized, and their leading industrial position got further confirmed. In the process of reform, with establishment of modern enterprise system, running of an enterprise was almost under control of the market rules (value laws, and competition laws). The government pushed state-owned enterprises towards the market, which made possible equal competition between state-owned enterprises and non-state-owned enterprises. Therefore, the government no longer posed any intervention towards production and operation of all sorts of enterprises. However, in the distribution field of important resources, the government still partly retained monopolized resource distribution system, which was mainly indicated in the following several respects according to study by Liu Xuejun:

Firstly, in the process of the complete marketization, national monopolization of the financial system was retained and strengthened.

Secondly, on one hand, commercialized reform of the bank consolidated interest motive and risk consciousness of bank business; on the other hand, monopolized commercial bank structure was formed with the major four state-owned banks as the subject.

Thirdly, control on bank rate was held continually.

Fourthly, in order to ensure that investment would comply with requirements of the government strategy, government sections still retained the system of approval on investment projects.

Fifthly, industry admittance policies and regulations of all forms were still preserved.

In a word, reform progress of marketization since 1978 was rather difficult. Due to inertia role of the traditional planned economic system, the reform has not been completely finished so far. Although structure of Chinese economic system has been greatly altered, the market has generally played a fundamental part in resource distribution in competitive fields, and basic framework of the new system has come into being. However, many structural elements of this framework have not been perfect, especially modern property right system, market system of production elements,

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credit system, social guarantee system, macro-control system, system of supervision on the market by government, and legal system, etc,. Compared with perfect market economic system, and with final target of the reform, there still exist disparities. Reform is still on the way. Especially in the current situation when the global economy is faced with crisis, intervention on the economy by government will be intensified, so it should be particularly noticed that revival of the old economic system should be avoided.

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