China's Economy: 60 Years of Progress

By Wu Jinglian

(Caijing Magazine) Since its founding 60 years ago, the People's Republic of China has been transformed from a centrally planned economy to a market economy. The journey has been fraught with twists and turns on a road paved with hardship, upheavals and reversals. It's been an important process, however, as any search for direction in the course of human development. And it's taught us valuable lessons about the entire process of a planned-to-market economy transformation.

China's modern history began six decades ago with a grand experiment aimed at realizing national development through a planned economic system based on public ownership. It was an experiment destined to fail. When an entire society eliminates the rights and freedoms of individuals to experiment and innovate, and only an elite few lead an entire nation toward a future filled with uncertainty, more often than not, things go astray. Even attempts to correct mistakes can be rigid and ineffective. Coming to realize that a mistake was made may involve only a small elite class, but fixing it requires concerted action by an entire society. And since a society's actions are not always right, a perpetual cycle of trial-and-error may result, forcing everyone to pay an unnecessarily high price that's difficult to measure.

Poverty necessitated a change for Chinese people 30 years ago. The central government stopped tinkering with its centrally planned economic system, sparking a spectacular transformation to a market economy. At that time, China decided to launch market reforms, and average citizens started regaining the right to control their own destinies. Individuals also gained to a certain extent a mission of shared responsibility for determining the direction of society's development.

One of the strengths of an ideal market economy is that an individual has freedom to pursue the goals he or she chooses. And because people have different natural gifts, as well as spells of good and bad fortune, the probabilities for certain individuals to find new paths to innovation can vary. As soon as an individual discovers a new path, others in society can share the benefits. Pricing mechanisms play an important role in this process, both because they reflect the level of scarcity and allow for optimal resource allocation, but more so because they provide an objective look at the behavior of people. Individuals that innovate can obtain fair returns through the market's pricing system.
Three fundamental elements of a market economy -- property rights, an open market and private enterprise -- are absent in a planned economy. On the basis of property rights, whether an allocation or organization of human or physical capital is accomplished through market pricing mechanisms, or by administrative order through enterprises, depends on which of the two methods is more effective. For similar economic activities, if an enterprise formed through administrative decree has operating costs higher than the transaction costs dictated by market pricing mechanisms, the enterprise is ineffective in performing the given activity, and the activity should return to the market. This kind of enterprise reorganization is commonly seen in market economies but never in planned economies, in which a whole nation is one, giant enterprise. And because there are no external market factors and pricing systems to maintain balance, the system ultimately becomes inefficient and starts to decline.

During most of the 60 years of modern China's development, much time has been spent on carrying out various economic reforms. From original struggles to system reform to developing a market system while maintaining the system of public ownership and a planned economy, and then on to a complete transformation to a market economy, the direction has been clear for a long time, and the end goals have gradually become more apparent. Property rights reform, market (pricing) reform, enterprise reform, and reform of the political system, working together, have to a great extent unleashed vitality in the national economy and led to an average growth rate of close to 10 percent per year for the past 30 years. The rapid pace of development has allowed China to become the world's third-largest economy.

Still, the going is toughest toward the end of any journey. The road to reform for China's economy is far from complete: Reform on property rights still has a long way to go, and many key decisions such as energy prices, interest rates and exchange rates are still tightly controlled by the central government. Reforms for state-owned enterprises in certain monopolized industries such as energy, telecoms and banking are even harder to push forward. Government and government-owned entities still control a major part of the national economy's resources. Incomplete reforms are one root cause of social problems such as corruption, social inequalities, economic imbalance and environmental deterioration.

Despite China's phenomenal success over the past 60 years, problems will accumulate unless national economic reforms are thoroughly implemented. It could be hard to avoid falling short of success during the last big push despite great accomplishments during the 31-year period of reform and opening up. If this happens, China's economy will lose a dependable foundation.

China's economic reforms have already waded into deep waters. If it is said that in the early days of reform all society benefited, then now at this new stage of reform it can
be said that certain entities including the government may lose certain vested interests. But now, there is no turning back. And there is reason to expect that more practical and effective reform plans will be push the country forward. —— *Caijing editors*

**Taking Root**

**China** as a nation has experienced great challenges as well as adversity since 1949. Success in dealing with these challenges can be attributed in no small part to the market reforms introduced over time. And the reform process is not complete. Only if China draws on the lessons of 60 years can the country permanently overcome today's challenges and realize the dreams attached to China's rapid rise on the world stage.

The sound of a firearms salute on Tiananmen Square during the nation's October 1 anniversary celebration welcomes a new era. Nonetheless, the success has a dark side. China's great economic recovery has caused some to grow boastful and think rashly, overestimating their abilities.

The process of hurredly adopting a socialist transformation by implementing the Soviet model for a centrally planned economic system did not stimulate the country's creative enthusiasm. On the contrary, it created a situation without proper incentives and lacking vitality. As a result, reform rose to a high place on the national agenda.

China, like the Soviet Union and East Europe socialist countries, attempted some economic adjustments starting in the 1950s to reduce inefficiency in their centrally planned economic systems. To inject vitality into China's economy, an "economic management system reform" plan was put forward in 1956. It aimed to implement some policy adjustments while maintaining the framework tenets of public ownership and a planned economy.

More than 20 years later, after much trial and error, the correct path to instituting market reforms gradually became clear. Even still, there were diverse opinions when...
questions were raised about how — and what kind of -- market economy to establish.

Now, China has successively adopted numerous measures to transform its planned economy into a fully functioning market economy. These measures have roots in different schools of thought in terms of economic theory. Over the years, goals and directions of the measures were often very different -- sometimes even contradictory.

In this article, China's primary reform measures will be used as benchmarks of the decades-long process. Economic reforms will be separated into three stages, the merits and faults of each reform measure discussed, and the effects of reform on China's economy and development path analyzed.

During the first phase, from 1958 to '78, the government implemented a decentralized command economic system. The focal point of reform was the central government's delegation of power and yielding of profit-making to lower levels of government.

The second phase stretched from 1979 to '93. This was a phase of increased reform that saw a greater focus on promoting the economy in areas beyond state-owned entities. Private enterprises grew in strength, which moved forward the entire national economy.

The third phase began in 1994 and continues today. It is a push-forward phase, with the goal of establishing a market economy and carrying out comprehensive reforms.

In China's reform process, elements of each phase are intertwined. Reforms
implemented in the early phase often contained elements that were seen in measures during later phases, and vice versa.

Let's consider the ways China's economy changed over the 20 years that began in 1958. Reforms in the areas of public ownership and socialist means of production gave the centrally planned economy a welcome push during this period, and the economy was able to accomplish some notable feats. But the system's inherent problems soon became evident. The entire national economy resembled one, large enterprise, with the central government functioning as head office and local governments the branches. Enterprises that should have been independent entities resembled production workshops operating under a parent company umbrella.

Like a big business, the central government issued directives and passed them on to lower level departments, which in turn gave orders to the workshops. This top-down system of order-giving was unusually complicated and oftentimes led to inaccuracies. It combined production with consumption and lacked the flexibility needed to make adjustments. To an outside observer, China's national economy might have appeared orderly. But, in fact, it had already fallen into a state of rigid inefficiency.

As central planning began dragging down the national economy, the central government tried to make some policy adjustments. However, constrained by the ideology of that period and limited knowledge, the adjustments in this early phase were little more than minor patches for the framework of a planned economy. Also, measures often deviated from their original plans — and sometimes moved in the opposite direction — when put into practice.

Later, it became evident that there was no way to root out all potential problems while reforming a centrally planned economy. On the contrary, whenever a policy adjustment was implemented by central planning's elite few, everyone in China was suddenly forced to participate, jolting the entire society. Moreover, the system lacked any sort of social safety net.

**Power Transfer**

**During** this phase, the central government started granting more administrative power to local governments. This policy marked the first major revamping of the planned economy. It was as if leaders of a parent company had granted a certain amount of managerial authority to subsidiaries. The adjustments increased competition among subsidiaries but, in essence, the system did not significantly change.

The central government was still the nation's largest enterprise, relying primarily on administrative decree to operate. It did not depend on market price signals to allocate
resources based on scarcity. To a significant degree, it was extremely dependent on accurate and detailed advanced planning. Without price signals to provide objective criteria, it was difficult to assess the pros and cons of subjective planning and make rational decisions. Intrinsic shortcomings of policy, as well as problems with execution and motivational issues, contributed to varying amounts of inefficiency, waste and loss.

In 1957, based on an August 1956 resolution approved at a meeting of the Eighth National Congress of the Communist Party of China (CPC), the central government instituted reforms and granted more administrative power to local governments. The transfer of power took effect at the beginning of 1958, creating a kind of decentralized command economy.

At the same time, massive numbers of people were moving into communes. The merging and reorganization of agriculture production cooperatives and the integration of governmental administration and commune management further strengthened the government's control of the rural economy as well as the entire society. This movement became the basis for the Great Leap Forward initiated by Mao Zedong in 1958.

The policy that granted administrative authority to local governments did not match Mao Zedong's line of thinking when he raised the subject in a speech called On 10 Major Relationships. As a result, changes in the structure of domestic politics in 1957 and '58 made the idea of transferring power to local governments and enterprises politically incorrect.
Prior to the Eighth National Congress, many controlling economic bodies and state-owned enterprise (SOE) leaders had already expressed a keen interest in Yugoslavia's experiment with "enterprise autonomy," and hoped China could draw lessons. At the congress, autonomy became a hot discussion topic. But later in 1957, CPC criticism of Yugoslavia's so-called "self-governing socialism" began to grow, and the idea of granting more power to enterprises was subsequently left off the reform plan agenda for China.

Mao Zedong's On 10 Major Relationships touched on how best to grant more power to enterprises, workers and individuals in order to "muster up enthusiasm." At the time, his ideas were very similar to those found in policies in other socialist countries, which were increasing material incentives for SOE workers through a process of "de-Stalinization." By 1957, a divergence in views between CCP and the Soviet Union regarding Stalinism was becoming apparent. The Anti-Rightist Movement was well under way, and "individualism" had been deemed as harmful as opposing the CCP and socialism. The movement demanded that people "cut the fetters and fame of wealth." That put the idea of using material incentives to muster enthusiasm among individual workers in direct conflict with dominant ideology.

In this political climate, policies granting additional power and profit rights could only be implemented for the sake of local governments. So a transfer of power to local governments became the basis for reform in 1958. "Institutional reform" was defined as "transferring administrative power to lower levels." And this kind of reformist thinking had a profound influence on China's future economic development.

The Eighth Plenary Session of the CPC, which convened in September 1957, was the meeting where the Great Leap Forward was launched. At the same time, it established an "economic administrative management system" to "make rapid progress in building a solid economic foundation." A five-member working group headed by committee member Chen Yun drafted three key regulations, including directives for improving industrial and commercial administrative management systems, and for dividing the financial and administration powers of the central and local governments.

Chen's group formally submitted these directives to the Standing Committee of the National People's Congress. The regulations were designed to give more power to local governments and delegate power to local administrative organs, generating motivational enthusiasm and giving free rein to local enterprise initiatives. On November 14, the standing committee ratified the regulations. They were to take effect in 1958. So the transfer of administrative power in 1958 primarily consisted of the following:

-- Transferring enterprise jurisdiction. The CPC Central Committee and the State Council jointly issued directives April 11 under a Regulation of the Transfer of Authority for Industrial Enterprises. The directives said that, aside from a small
number of special and experimental enterprises that the State Council deemed important, management authority for all enterprises would be held by individual local governments. As a result, 88 percent of enterprises and state-owned institutions that were once subordinate to the central government were transferred to local governments. Some were transferred to neighborhoods and communes. To put the matter in perspective, industrial enterprises subordinate to the central government accounted for 39.7 percent of China's total industrial output in 1957. But in 1958 that number decreased dramatically to 13.8 percent.

-- Transferring resource allocation authority. This step included decreasing the assortment and quantity of goods and resources that were once uniformly dispersed by the state planning commission (called "goods under the unified ration plan" or "type one goods") and departments under the State Council (called "department-controlled goods" or "type two goods"); switching from the central government's "unified distribution" plan to a system of "regionally balanced allocation" based on the needs of individual provinces, cities and autonomous regions; and giving local government planning offices authority to allocate and transfer goods and resources.

-- Transferring government approval rights for capital construction projects, investment and credit. When projects went beyond prescribed quotas, local governments had to submit a brief petition to the state planning commission. All other projects could be approved locally, and decisions to invest in projects falling below the quotas could be made by local governments. This gave local governments the power to initiate all kinds of projects and raise funds, including raising funds for large-scale projects that exceeded the prescribed quota. Local banks could issue credit according to each area's "production requirements." They could also decide the amount and timing of credit issuance.

-- Transferring finance and tax authority. The decision to implement "tax fanning" was made to strengthen local financial resources and expand the economic power of local governments.

-- Transferring administrative authority for labor and recruitment. The authority to implement labor and recruitment planning policies had been the responsibility of the central government. Now, it would be delegated to provinces, autonomous regions and municipalities.

In addition to granting more autonomy and authority to local governments, the 1958 reforms included certain measures that granted more power to enterprises. Some measures reduced indicative planning targets by cutting the national planning commission's directive targets from 12 requirements to eight in terms of principal product output, staff sizes, wage levels, profits, etc. Other measures altered the original system for "enterprise rewards" (factory manager funds) based on certain proportions of profits, according to industry, by launching a system based on a "proportionally
equal sharing of profits."

Other measures expanded the rights of enterprises to organize their workforces, excluding leaders and key technical personnel. Enterprises were given authority to manage their own employees and adjust structures and personnel as long as they did not increase total employment. Enterprises could allocate a portion of capital for company use. They also had the authority to increase, decrease and/or discard fixed assets.

**Chaos vs. Rigidity**

*After* these reforms, local governments gained enough power and resources to make their own decisions. And while many enterprises at many levels saw a corresponding rise in autonomy, it still seemed the overall reform plan had left local governments in charge of "workshop" production. Competition rose among local governments for control over enterprises and resources, but no pricing mechanism provided signals to guide decisions. Neither was there natural selection to drive out ill-performing enterprises. Thus, these reforms did not lead the economy in a positive direction; instead, they set the stage for the Great Leap Forward.

On the other hand, since planned economic policies were coming from an elite few, it was easy for ideology to restrain reforms. Knowledge levels, political positions, and even fluctuating moods played roles as well. Indeed, during this phase of reform, politics deeply influenced China's economic progress.

By refusing to alter the framework for maintaining a planned economy - while allocating resources through administrative decree and dividing power among local governments - the planned economy was decentralized. This, coupled with a mass movement of China's population to rural communes, paved the way for the
Great Leap Forward.

Under this system, all levels of government responded to Mao Zedong's call to "surpass England in three years, and surpass the United States in 10 years." Local governments fully utilized their power to accumulate resources, launch industrial projects, conduct large-scale employee recruitment, and freely allocate agricultural resources. It was all in the name of achieving impossible feats ordered by the government, such as doubling annual steel production. The result was a war for resource control waged among regions, government departments and enterprises. The practice of "excessive egalitarianism" -- in other words "egalitarianism combined with free resource allocation and the authority to collect" -- was in fashion. And the economy was is disarray.

Due to chaos in the economy, production declined substantially. Mass consumption and a wasting of resources ensued. Local leaders exaggerated statistics in hopes of pleasing superiors and getting credit for the achievements of others. Only later did facts prove that their production claims for steel, grain and other goods were completely false.

Meanwhile, some leaders let the veneer of success go to their heads. During a food shortage, as nationwide famine was about to break out, Mao Zedong was asking, "What if there is too much grain?" Gradually, communes adopted new food distribution methods, such as public cafeterias, to feed "each according to his need."

By the end of 1958, the negative implications of these practices were finally revealed: Production had declined, enterprises had suffered major losses, daily necessities were in short supply, and the national economy was in dire straits.

In 1959, from July to August, the Eighth Plenum of the Eighth Central Committee of the CPC (the Lushan Conference) convened at Lushan in Jiangxi Province. At the beginning of the conference, Mao Zedong said the main purpose was to review experiences and lessons learned from the Great Leap Forward. Mao admitted the movement was "unbalanced and upset natural proportional relationships in the national economy." He also called the transfer of power "excessive." Later, after Defense Minister Peng Dehuai heeded Mao Zedong's request for leaders to honestly reflect on the experiences and lessons of the Great Leap Forward, Mao Zedong decided to extend the conference an additional 10 days. Mao Zedong then criticized Peng, and launched a nationwide movement to "oppose rightist tendencies." Thus, the political climate shifted dramatically from "correcting the left" to "opposing the right."

The movement to "oppose rightist tendencies" led to a second wave of "excessive egalitarianism, causing the economy further deterioration. In 1959, the nation produced a total 170 billion kilos of grain -- down 30 billion from the 200 billion kilos
produced in 1958. In 1960, gain output decreased to 143.5 billion kilos — less than the 143.7 billion kilos harvested in 1951. Widespread famine began to grip the nation.

Because of limited access to information and a lack of proper prevention measures, widespread malnutrition started appearing in cities and towns, leading to mass disease. Between 20 million and 40 million people in rural areas died prematurely during this period.

In autumn 1960, the CPC Central Committee finally settled on an Eight Character Policy to implement a process for "regulation, consolidation, replenishment and improvement" of the national economy. The recovery was lead by Chen Yun and a group of economic leaders from the CPC Central Committee. Its aim was to adopt measures to overcome grave economic problems caused by the Great Leap Forward and communes.

Here are some of the activities that paralleled introduction of the Eight Character Policy:

-- The CPC Central Committee convened in January 1962 with central authorities and cadres from five levels participating in a working conference on growth (called the Seven Thousand Member Plenary Session). During the conference, Mao Zedong took personal responsibility for mistakes of the Great Leap Forward and tried to calm resentful cadres. At the same time, he called for unity to overcome the challenges that would lay ahead. A group of Central Committee leaders led by Chen Yun was responsible for economic recovery and accepted the daunting task of "regulating" the national economy.
-- The central government withdrew powers that had been granted in the 1958 reforms to local governments in areas of finance, credit and enterprise jurisdiction.

-- The policy was based on a system that relied on a high degree of central decision-making power for allocating scarce resources. Key measures included ordering steel producers to completely abandon small-scale industries tied to "folk methods" of production as well as "small enterprises using modern methods." Also, roughly 30 million peasant workers who had moved to cities and towns for work were told to return to the countryside. A policy that called for closing, discontinuing, merging and restructuring industrial enterprises was implemented in cities.

Several months after the reforms were implemented, the economy gradually stabilized. And by 1964, it had largely recovered. But while people rejoiced over economic recovery, problems inherent to central planning had resurfaced. As a result, more attention was given to further reform.

However, before the Cultural Revolution ended in 1976, an ingrained ideological belief that socialist economies were only able to allocate resources through administrative decree made it difficult to rally political support for market-oriented reform. As a result, transferring power to local governments seemed the only possible avenue for reform. This resulted in new policies that mirrored the 1958 reforms that had shifted administrative division of power. For example, large-scale economic reforms in 1970 were heralded with a 1958-style slogan: "Decentralization is the revolution. The more decentralized, the more revolutionary."

So between 1958 and '76, multiple transfers of administrative power brought disorder and ended in a return to centralized power. This in turn led to a vicious cycle in which decentralization yielded chaos and re-centralization choked the economy.

**Rethinking the Rules**

The curse of choosing between chaos and rigidity hovered like a dark cloud, prompting some policymakers to rethink the entire system. Some blamed the intrinsic shortcomings of a centrally planned economy based on state property ownership. Their reflections gradually deepened and clarified official understanding. And the ideology shifted slightly, laying a foundation for future reform.

The first person to seriously criticize "power transfer" ideology was economist Sun Yefang. In a report to economic leaders in 1961, Sun pointed out that the system's fundamental problem was not how to divide power between central and local governments. Rather, he said, it was a problem that concerned "enterprise operations and management." According to Sun, only by granting authority to enterprises "could
the national economy be stimulated."

Sun's critique was not based on concerns about the effective allocation and use of scarce resources, but rather as a way to support an ideological framework for transferring power to lower levels of government and encouraging enthusiasm. Therefore, he didn't explain clearly from a theoretical standpoint why transferring power to lower government offices could not solve the nation's economic problems, saying only that granting more power to enterprises and "expanding enterprise management rights" would raise the nation's productivity.

Furthermore, China at that time was politically controlled by an extreme left. Even if Sun's request for expanding enterprise decision-making power within the framework of a planned economy had been heard, it would not have been accepted by central government authorities. As a result, not long after he raised his points, Sun was dubbed a "radical revisionist," criticized and persecuted.

But in 1976, after the extreme left lost power, Sun's ideas began to win widespread acceptance. Only years later -- in the mid-1980s -- did scholars in China start using modern economic theory to analyze the positive and negative effects of the "transfer of administrative power." In the course of this new debate, economists adopted one of two schools of thought.

The first school held that transferring administrative power played an important role in pushing forward China's economic development, particularly outside the state-owned sector. For example, in the 1980s, property ownership rights were transferred to local governments through adoption of a policy of delineating income and expenditures in fiscal budgets. This encouraged local competition, which in turn stimulated enterprise development and production. After local governments received a certain degree of financial independence, local officials acting in the best interests of constituents used their power to let towns and township enterprises raise capital,
manufacture goods, sell products and conduct other business functions. This was a major contributing factor for the rapid development of private enterprises.

Scholar Zhang Wuchang once summed up China's 30 years of market-oriented reforms with an exceptionally high appraisal of the policy that transferred power to local governments. He thinks it was precisely these reforms that brought about regional competition and facilitated the rapid development of China's economy.

Economists belonging to the other school of thought are critical toward the idea that transferring administrative power was the main catalyst for economic reform. They think the central government should not implement a division of power as an overarching reform goal, but rather first establish that there are two completely different ways to divide power. One is a division of power under a market economy (or economic division of power). The other is a division of power under a planned economy (administrative division of power). To fundamentally improve implementation and raise overall efficiency, they say, governments should employ only an economic -- not administrative -- division of power. Their grounds for argument are as follows:

-- For a planned economy to function -- as well as engage in meticulous planning and organization -- an essential condition is strict enforcement of orders that have been passed down from higher ups. If orders are not enforced, and each department acts on its own by allocating resources according to local interests and the whims of senior officials, complete disorder in the economy will be the end result. In short, resource allocation in a planned economy essentially requires a dictatorship. A planned economy with decentralized power is actually much worse than a planned economy with centralized state power. The only way to shake off the curse of choosing rigidity via a planned economy with centralized power or chaos through a planned economy with decentralized power is to carry out market reforms, establish a market-based system, tolerate healthy competition, and allow price mechanisms that let scarcity create a basis for resource allocation.

-- A market economy is in many ways a decentralized economy. In a market system, individuals and enterprises take their own initiative to reach decisions over what and how much to produce, and who to produce for, based on pricing signals and self-interest. Dividing administrative power has a short-term effect by being able to encourage local governments to energetically support enterprise development. In the end, however, this leads to forming a system based on cozy relations between local governments and enterprises. It also facilitates regional protectionism and breeds corruption.

From another perspective, the administrative division of power policies implemented separately in 1958, '70 and '80 certainly provided the potential for competition among regions. Yet the policies led to growing regional protectionism and a trend toward
dividing markets. Until the mid-1980s, regions were effectively sealed off from one another. Partitioned markets and local protectionist behavior became significant obstacles to an integrated, national market. Some even labeled China a feudal economy.

As a result, China's economy grew in strength only after the mid-1980s, as breaking down regional barriers and fully integrating market mechanisms became important reform targets.

Numerous failed attempts at reforming the planned economy system forced Chinese leaders to reflect and reconsider the direction of reform. Allowing operational "microenvironments" outside the public system was the most important positive adjustment during this stage. This built a foundation for non-state economic development with an incremental reform strategy.

Allowing economic activity outside the public arena was a landmark decision. It began with agricultural land reform in the village of Xiaogang, Anhui Province. Of course, it was a massive undertaking to conduct systematic, theory-based analysis following small-scale testing, leading to gradual institutionalization and promotion of successful results. This was a "crossing the river by feeling the stones" strategy, which seemed to follow no clear theory. But it was inherently rational, as small, separate cases were permitted to test the direction of social development, ensuring positive results throughout society.

When incremental reform begins to take vigorous hold and win society's approval, it attracts an increasing amount of resources, provides an important center of support for the national economy and assumes a superior position due to pent up competition. An important thing to consider is that incremental reform gradually reflects scarcity of resources and forms a pricing system for resource allocation, turning a public economy in many areas toward a new pricing system. So in China, as soon as the door to reform was thrust open, the pros and cons of the new and old systems were immediately apparent. And the push and pull of economic forces meant the country would never return to the past.
In October 1976, members of the Gang of Four led by Jiang Qing, Mao's wife, were arrested and the Cultural Revolution ended, allowing a change in direction for the Chinese economy. Reform began with an expansion of decision-making power among large SOEs.

When these reform tests failed, Chinese leaders placed hope in the non-state economy. They created a flexible system for a private economy to sprout and gradually develop into a new source of growth for the Chinese economy. We call this reform strategy incremental. Economic reforms and successful economic development since then can be traced back to this strategy.

However, perpetuation of a two-track system presented a series of difficulties.

**Reform Frustrations**

The traditional planned economy proved unsustainable. But some combination of ideology, public awareness and inertia from the original system meant a new system was unlikely to simply fall from the sky. While a reform trend was clear, its direction had been disputed. Now, to improve the system, many wondered whether the change should emphasize an unraveling of power to local governments, or give more autonomy to enterprises. Another question was whether to use planning to fully regulate the market or establish a full market economy.

A mild reform held the upper hand in debate and practice, but its intrinsic shortcomings once again came to the fore. At the same time, market-oriented reform, including property rights reform, was tried in the private sphere and showed great vitality.

After the decade-long Cultural Revolution, during which hundreds of millions of people were persecuted, most Chinese had lost faith in a total dictatorship. Society had come to a unanimous conclusion that the old system could not be sustained. Thus, the consensus was that reform and opening the country was necessary to save the nation. As Deng Xiaoping said, "We must reform. We must open up. The sealed-off situation of the past 20 years must change. In implementing a policy of reform and opening, we are of one mind. This is tied to the 10-year Cultural Revolution. The lesson of this disaster has been too profound."

The first reform step was "thought liberation" to break the fetters of leftist thinking at a historical meeting -- the 3rd Session of the 11th CPC Meeting. Hu Yaobang, then-chairman of the CPC Central Committee Party School, supported the newspaper Guangming Daily in publishing a commentary entitled Practice Is the Sole Criterion for Testing Truth. This essay marked the start of a national movement promoting
"enlightenment" with a foundation based on "thought liberation."

Thought liberation meant ideas such as "class struggle as the guiding principle" and "continuous revolution under the dictatorship of the proletariat" were opened for debate. The once-sacred planned economy system and a total dictatorship imposed on the bourgeoisie within and outside the party (including so-called bourgeoisie intellectuals) could be changed. The campaign broke the shackles of decades of rigid thinking and inspired workers, peasants, intellectuals and cadres to open their minds, solve problems and seek development. Leaders heeded personal lessons and reviewed experiences from other countries. These elements allowed them to craft various transformation visions. The government sent delegations to the United States, West Europe, East Europe and East Asia to study systems in other lands, seeking methods for promoting rapid development.

In this atmosphere, decision-makers pushed forward reform. At an internal brainstorm from July to September 1978, documents were released describing rapid economic development in Yugoslavia and Romania that had been brought on by foreign investment and enterprise reform. Vice Premier Li Xiannian, in his final report at the meeting, said the top priority was to change backward production forces and ensure a multifaceted transformation in relations for production as well as changes in industrial and agricultural enterprise management, state management of industrial and agricultural enterprises, personal activity, and thinking.

There were two ideas about how to reform the economic system. The first mainly called for giving more decision-making autonomy to major SOEs. The second had a broader scope:

It said reform should result in a socialist commodity economy, one completely unlike the Soviet model.

One advocate of the later was Xue Muqiao, a veteran Chinese economist and participant in central government economic leadership since 1949. Working at the State Council Office for Restructuring in the summer of 1980, Xu wrote a draft called Preliminary Views on Economic Reform that said, "China at its present stage of socialist economy is dominated by public ownership of the means of production and a
commodity economy, in which many economic sectors coexist. The principle and direction of China's economic reform should be to develop the commodity economy by consciously using the law of value and shifting from a pure, planned economy to planned regulation that lets the market adjust the economy while maintaining dominant public ownership of the means of production."

In September 1980, at the First Secretarial Meeting of Provinces and Cities, Xue offered a work called Opinion in which he said, "So-called economic reform is meant to answer the question of what type of socialist economy to establish in China. This is the basic direction of socialism's construction. The economic management system reform plan that will be released is an economic constitution." Although Xue's Opinion was approved by Hu Yaobang and other leaders, it was not included in the government's final decisions.

Another person who influenced theory and policy regarding China's economic reform was Du Runsheng, a long-time rural economy researcher and one-time assistant to Deng Zihui, a rural work leader criticized by Mao Zedong. Following the village contracting reform of the early 1980s, Du proved his ability to influence rural economic policy. Drawing on the theoretical achievements of modern economics, he stood for the complete establishment of a market economy.

The first line of thought received support from workers and SOE leaders. Sichuan Province, based on this line of thinking, began reforms based on expanding enterprise autonomy. In October 1978, Sichuan selected six, state-owned factories to act as pilots for the experiment. The results were positive, so the experiment in Sichuan was expanded to 100 SOEs. By the end of 1979, more than 4,200 enterprises were participating in the test nationwide. And the next year, the number grew to 6,600. The value of their output accounted for 60 percent of budget projections nationwide. They also accounted for 70 percent of China's corporate profits.

### Outward Looking

The Chinese have a saying: If the route cannot be traversed by land, go by sea. As reforms inside the system hit roadblocks, decision-makers who oversaw reform displayed tolerance and flexibility by shifting from implicitly allowed, small-scale free market experiments to gradual institutional recognition. With the household contract system as a foundation, ownership reform began, setting the private sector afire. From then on, opening doors to the world and internal reform went hand-in-hand.

Private ownership and a pricing system outside the planned economy were officially recognized as they grew and developed. The non-public sphere and market prices put pressure on the public sector, adding additional impetus for reform. But the planned
economy and market economy continued to run in parallel, leading to a two-track system.

After expanded SOE autonomy hit a roadblock, Deng Xiaoping shifted reform's focus to the rural, non-state economy from urban SOEs. His most important immediate change was to repeal commune-supporting prohibitions on a household contract responsibility system.

In September 1980, the CPC Central Committee decided to let farmers voluntarily submit to a household contract responsibility system. Within just two years, the system had replaced the commune system almost nationwide, reshaping the rural economy. From this foundation, collectively owned village and township enterprises began to flourish. And on this point, China differentiated itself from countries in East Europe that had started reforms by using large, SOEs to create market-leading enterprises in the private sector, before relying on these companies for economic growth. China's strategy became known as incremental reform, or "reforming outside the system first."

After incremental reform saw initial success in the agricultural sector, CCP and government leaders extended the experiment to other sectors. While maintaining state-owned dominance, restrictions on private entrepreneurship were gradually relaxed. Combined with the previous easing of restrictions on private investment, the non-state economy was able to develop from the bottom up.

The development of the non-state economy was apparent in three areas:

First came allowing non-state enterprise growth. Non-state economic development has always been politically sensitive in China. Even during the post-Cultural Revolution period, doctrines of the Mao Zedong era still dominated. These were reflected in slogans such as "larger, more public is better," "cut off the tail of capitalism" and "let capitalism die." Thus, as the reform era began, a circuitous route was needed to develop the non-state economy. But after the household contract responsibility system succeeded, these old thinking patterns finally faded. Restrictions on private enterprise hiring were eased in 1983. In other words, private enterprises finally achieved legal status. Since then, the private sector has grown at an astounding rate.

Second was the use of "special economic zones" as a "microenvironment" for linking certain areas of China to the global market. In the history of global economic development, domestic market development has always been a protracted process. China's previous commercial culture had been extremely weak, and under a planned economy during the first 30 years of the People's Republic, market forces were almost completely wiped out, making building a domestic market difficult.

Considering the situation, it would be nearly impossible to create a domestic market with links to the global economy within a short period. Therefore, building on the
experience of other countries in establishing export and industrial processing areas, China used coastal areas and those close to Hong Kong, Macau and Taiwan as well as other areas with large overseas Chinese populations to create microenvironments as bases for opening to the outside world.

In 1979, the central government enacted so-called "special policies" with "flexible implementation" in Guangdong and Fujian provinces to take advantage of their proximities. In 1980, special economic zones were created in Shenzhen, Zhuhai, Shantou and Xiamen. Another 14 port cities were opened in 1985. Opening to the outside world created trade regions in coastal areas, along rivers and in border areas.

The strategy's most important achievement was allowing a private economy to develop from the bottom up. This gave it strength. In the 1980s, private industry grew at twice the rate of its state-owned counterpart. By the mid-1980s, the non-state sector was playing a pivotal role in industrial production and the national economy. The private sector had risen to comprise more than one-third of industrial output. In the retail sector, the non-state sector was growing even faster.

Thus, more than a decade of incremental reform brought rapid growth to the Chinese economy. From 1978 to '98, the total value of domestic production increased an average 14.6 percent annually, while per capita disposable income among urbanites grew at an average annual rate of 13.1 percent.

**Two-Track System**

**Continued** development of the non-public economy and market pricing system eventually clashed directly with the public economy and state price-setting. The two-
track system was unsustainable. One track lacked impetus for reform and left the non-state economy at a competitive disadvantage, since swathes of the economy had been protected by price command for so long. The other track risked rent-seeking and corruption, upsetting economic order, because resource holders could take advantage of differences in command system and free market prices to make huge profits. The two-track system made an important contribution to the economy at one historical stage. But in time, it fell out of sync with requirements of economic development – even to the point of impeding the next reform step.

While maintaining the dominance of the state-owned economy, incremental reform allowed development of the private economy and brought about a partially free market system. That led to the two tracks of command and market.

Under the planned economy, means of production were uniformly distributed among economic units, and prices were only an accounting tool. Consumer goods were uniformly managed by state-owned businesses and prices fixed by price-management departments.

At the beginning of the reform and opening period, SOEs were given autonomy to sell products. The State Council released in 1979 its Provisions for Expanding the Operating Autonomy of State-run Industrial Enterprises, which let companies sell products through their own channels beyond quotas. This opened the second track for circulating products -- the market.

At the same time, the birth and development of quota-free private enterprises made obtaining raw materials and other resources from the market a necessity. By the mid-1980s, 31 percent of nationwide industrial product value was private, and market allocation of the means of production was constantly expanding.

In January 1985, the State Price Bureau and State Materials Bureau issued a notice entitled On the Opening of Pricing for Over-Quota Industrial Means of Production, which let enterprises buy and sell products "outside the plan" at market prices. This began the two-track system for supplying means of production. The approach was set 1983 as a base year and for SOE production quotas; anything produced over 1983 levels could be sold at market prices.

Because state and private sectors coexisted under incremental reform, the two-track system existed in a number of areas beyond production allocation and pricing. For example, its influence was evident in lending rates at national banks, market interest rates, foreign exchange swap market prices, and official currency exchange rates.

Economist views on the advantages and disadvantages of the two-track system varied widely. Lawrence J. Lau, Qian Yingyi, Gerard Roland and Zhang Jun gave positive evaluations of the two-track system's role in stabilizing production in the state-owned
economy and realizing Pareto improvement. Through general equilibrium analyses, they described Pareto improvement characteristics of two-track price liberalization.

A 1986 study by the National Institute of Economic System Reform described the positive role of the two-track system from both economic and political perspectives. The report said that under the two-track system, from an economic point of view, "Whether an enterprises increases or decreases production or inputs, the price of the increased or decreased portion is decided by the market. This also means the market price has, in reality, played a deciding role in marginal corporate outputs and inputs, and through this marginal use acts to adjust the signals and impact of short-term supply."

From a political perspective, the report continued, "Within the two-track system exists an administrative system for allocating resources. Under certain conditions, the monetization of vouchers will be transformed into the monetization of power. That is, the power of voucher allocation is in fact the power to allocate money, meaning power to allocate vouchers itself can be measured in monetary terms; it can make power a type of currency. This type of degenerative behavior in economic terms is extremely reasonable. As long as the voucher monetization mechanism is effective, and administrative power derived from the planned economy continues, it is completely natural to consider the allocation of every kind resource as capital."

American economists Kevin Murphy, Andrei Shleifer and Robert Vishny took a different view. They thought that if all prices were not simultaneously liberalized, distortions of resource allocation would result. Moreover, unequal operating conditions would surface among SOEs, which could obtain hidden subsidies, and private companies, which could only obtain raw materials, equipment and loans from the market, and that these conditions would increasingly impede development of the private economy over time.

Other Chinese scholars, including myself, are now paying close attention to the social and political consequences of the two-track system. We think there are two consequences of this institutional arrangement. On the one hand, as some scholars have said, it gives people a certain amount of space for entrepreneurial activity, allowing all
sorts of private enterprises to grow. On the other hand -- and we must be on guard against this -- if this type of institutional arrangement of "power monetization" or "power capitalization" continues or intensifies, a rent-seeking environment will result. And that would plant seeds for spreading corruption. If we are unable to adopt further market-oriented reforms in time, and eradicate the roots of corruption, we will face serious economic, social and political consequences.

Two tracks -- state-based and market-based -- persist in the economy today, suggesting a high degree of inefficiency in public sectors, and that pricing is not entirely based on the market. Remnants of the planned economy permeate, and ways these conflict with China's market economy and private ownership system are becoming increasingly evident.

China's economic reform strategy has shifted from incremental to comprehensive. This is a necessary course for a new era. Primary reform measures have included a "double-track" pricing system as well as bold reforms for SOEs. These reforms have achieved some success and provided crucial contributions to China's rapid development. But due to a variety of factors, implementation of certain measures is lagging, burdening the reform movement. Immense challenges remain.

Reforms for many key industries in the national economy such as energy, telecoms, banking and oil are difficult to implement. Energy prices, interest rates and exchange rates are still tightly regulated by the central government and, thus, cannot accurately reflect levels of scarcity. This negatively influences the efficiency of resource allocation. An even more serious problem is that the central government and state-owned entities still control most of the nation's resources. This is out of line with market economy modes of production. As a result, we see examples of the nation benefiting while the people lose.

Years of experience, through trial and error, have proven that unless reforms are thoroughly implemented, vested interests rise and become major obstacles to progress. This in turn leads to a variety of social problems including corruption, rent-seeking and social inequity. The government is often forced to further deepen reforms to resolve these problems. Now, since reform has reached an advanced stage, delays can no longer be tolerated.

In the mid-1980s, as conflicts between reform and the planned economy intensified, support grew for shifting from a partial market reform policy to more comprehensive reforms. Finally, with leadership support, the policies turned comprehensive in 1986.

**Testing the Waters**

*During* this new phase, reform policies extended to state-owned entities, and moved
to an urban from rural focus. Measures encouraging a more complete pricing system emphasized market mechanisms, taxation and accounting. The aim expanded from strictly economic to include political reform. These measures made major headway, especially in restructuring ownership rights and establishing a macroeconomic system. However, due to unexpected events and reform-blocking moves by certain vested interests, economic and political reform experienced a major setback. Expectations went unmet, making future reforms even more difficult.

Deng Xiaoping was a firm advocate of incremental reform, but he wasn't satisfied with accomplishments of the early period. While sectors of the economy outside state control could function as a center of support for thorough reform, Deng offered a new reform strategy by pushing for updating SOE reform requirements. In October 1984, the Third Plenary Session of the 12th CPC Central Committee convened and approved the CPC Central Committee Economic System Reform Resolution. The strategy had changed.

In early 1986, then-prime minister Zhao Ziyang called for a complete set of reforms focusing on pricing mechanisms, tax schemes and accounting. By April, the council established an office dedicated to designing and planning economic reforms. This office, under direct leadership from the council and the CPC Central Committee Finance and Economics Leadership Group, drafted the Seventh Five-Year Plan for reform, focusing on pricing mechanisms, accounting, finance and trade. Pricing mechanisms were to adopt methods similar to those implemented in Czechoslovakia in 1967 and '68, using a policy based on a gradual reform course. A new motto was "first adjust, then set free." The plan's first step was across-the-board price adjustments. Later, perhaps in a year or two, the market would gradually be allowed to determine prices.

As for taxation, primary measures included a change from the established revenue sharing to a tax sharing system, along with introduction of value-added taxes.

Deng praised the reform plan and called for its immediate implementation. It was approved by the council in August 1986 and took effect the following January 1. Deng also called for political reforms focusing on separating party and government functions, and letting China's political system adapt to demands of a market economy.

Yet the two tracks remained. Double-track pricing meant a continuing legacy of "state syndicate" government control of resource allocation, creating friction and building pressure. To remove this legacy, a complete set of reforms had to be thoroughly implemented. Deng, because he recognized the importance of economic and political reform, made these top priorities in 1986. He said, "Without accompanying political reforms, we cannot guarantee the success of economic reform, and we cannot continue to move forward with progress. Productivity will be hindered, as will the realization of the Four Modernizations." Regrettably, these reform measures were not successfully
implemented at the time.

Academic and government leaders have often held differing views of economic reform. Early on, State Council leaders insisted on a complete reform focusing on pricing, taxes and accounting. But in October 1986, the council shifted to reforming SOEs, implementing the "chengbao" (contract) system over the next two years, and returning once again to the old, two-track method. This sidetracked an opportunity to advance comprehensive reform, leading to an intensification of administrative corruption, inflation and social problems, and it was ended by a market panic in 1988 and political crisis the following year.

Some politicians and academics blamed market reforms for the 1988 crisis and 1989 political turmoil, saying getting rid of the planned economy to make way for a market economy had actually transformed the system to capitalism from socialism. As a result, old ways of thinking were revived. Only after Deng promoted further reforms in a speech while touring southern China in 1992 did the government welcome a new wave for reform and opening up.

A resolution passed by the Third Plenary Session of the 14th CPC Central Committee in early 1994 led to new measures for taxation, finance, foreign-exchange controls, enterprise regulation, social security and SOEs. This was a renewed push for economic reform. At the same time, the State Council launched an experiment in modern enterprise institutional reform aimed at implementing the program on a wide scale after testing the waters. Exchange rate controls were initially the most successful of the reforms, as China reached a goal to manage a floating exchange rate. Measures on finance and taxation also moved ahead, on schedule. But some measures, such as SOE reform, failed to match demands of a market economy.

By the mid-1990s, progress was in place with a new macroeconomic system. Ownership was restructured as well. This was reflected by a noticeable shift in
economic activities that had been entirely state-owned. By that time, the proportion of state-owned entities with national economic influence had declined substantially. However, in terms of establishing a base foundation for a market system of property ownership, reform measures had yet to peak. In 1993, even though state-owned or state-controlled entities accounted for less than half of China's gross domestic product, the government and SOEs were still primary allocators of scarce resources. In terms of capital, state-owned entities controlled 70 percent of the credit market. In addition, because of the government and SOEs dominated the economy, it was difficult to implement sound reforms in areas of finance and taxation.

The fundamental reason was that, under the old planned economy, the state syndicate that Vladimir Lenin once referred to in The State and Revolution - also known as Party-State Inc. -- was at the very core of the system. Hence, it was difficult for many to come to terms with a free market system based on private enterprise. Supporters of the old system and those with vested interests continued using all kinds of excuses (including political excuses) to hinder reform and restructuring of state-owned entities. Reform again met significant resistance.

**New Century**

As reforms deepened, a battle between pro- and anti-reform factions became increasingly fierce. To a certain extent, later reform measures were far more difficult to implement than those from the early period. Most resistance to early reforms stemmed from ideological differences, while later struggles revolved around vested interests. Early reform measures were characterized by Pareto improvements in the economy, whereas later reforms had the potential to damage those with vested interests in the status quo. Promoting political and monopoly SOE reforms meant the government had to point a finger at itself. Because of this, reform attempts reached new levels of complexity, and implementation's pace noticeably slowed.

The 15th National Congress of the CPC in 1997 saw important breakthroughs in terms of state property ownership reform. The assembly mandated restructuring of ownership and established a long-term basis for a new system. It also drafted a constitutional amendment to implement these measures.

The restructuring had three primary components. First, the state-owned economy's scale was to be reduced through privatization, and state capital was to be withdrawn from key branches of the economy. In addition, various methods for accelerating productivity and development through public ownership (as a means of production) would be sought. Finally, non-public sectors of the economy were declared an important part of a socialist market economy, and the development of individual, private enterprises was encouraged.
One clear improvement was the system of ownership, as the development focus shifted to multifaceted enterprises from an exclusive focus on state-owned sectors. Alongside a small number of monopolized industries, private enterprises began occupying more dominant market positions. And in terms of employment, private enterprise became the main force: The percentage of Chinese workers employed by private enterprises reached 72 percent in 2006.

Second, state-owned economic sectors saw reform progress. The main signs of this included SOEs changing from a structure-based system with complete capital control by the state to an enterprise system based on diversified shareholding. Presently, outside the banking sector, most second-tier SOEs have reorganized and become companies in which the government is a majority shareholder. Among banks, the 21st century has seen overseas public listings for four, major state-owned commercial banks so far, providing a solid and necessary foundation for China's financial industry. And share diversification provided a basic framework for a new system of corporate governance among enterprises.

Although China established a basic market economy framework before the turn of the century, the system was still missing a number of key elements. Missing were a functioning financial market and a legal system based on market needs. Hence, original goals for a new economy remained distant. For this reason, in 2003 the Third Plenary Session of the 16th CPC Central Committee passed a resolution to correct certain problems with the socialist market economy. Implementation of this policy met some resistance. And as reforms slowed, a new sense of uncertainty emerged.

Mandates from the 15th National Congress of the CPC and the Fourth Plenary Session of the 15th CPC Central Committee markedly improved the overall balance and distribution of state-owned sectors of the economy, as well as SOE share restructuring. By the early 21st century, most small- and medium-sized SOEs, including various town and township enterprises under government control, had undergone extensive restructuring. Most enterprises became wholly owned or incorporated companies. But the wheels turned more slowly when the reform train reached state-owned monopolies in the oil, banking and telecom industries.

New controversies surround whether certain crucial state-controlled industries should move forward with privatization, or slide back. Some argue the portion of state ownership in certain industries should be increased. In 2003, a group of officials from the State-owned Assets Supervision and Administration Commission announced that a state-controlled economy was a foundation for CPC governance, sparking sharp ideological debate. Even though the CPC position was clarified in 2004, a certain amount of support for this ideology still exists today. After a dispute over the general direction of market reforms in 2004, the media started referring to "increased nationalization" and "new nationalization."
This reverse trend took shape in two ways. Private enterprises allowed to operate in certain sectors of the economy were kicked out. In addition, some wholly state-owned and state-controlled (through majority shareholding) enterprises began acquiring small- and medium-sized private enterprises, strengthening monopolies.

At this time, the central government began administrative intervention in the microeconomic activities of enterprises, increasing macroeconomic regulation.

In the fourth quarter 2003, China's economy began to overheat. In response, central authorities adopted a series of cooling measures, focusing on macroeconomic steps. When an economy overheats, namely in a situation in which aggregate demand greatly exceeds aggregate supply, the government should regulate the economy indirectly, such as by adjusting exchange rate policies and reserve fund ratios according to market conventions. Of course, since China's market reforms were incomplete, further administrative measures such as window guidance for bank credit were needed. Yet these measures should only be supportive and, during implementation, the government should admit limitations and possible side effects.

However, at the time, after analyzing macroeconomic trends, the overall consensus was that China had experienced only a partial overheating. Thus, the government's main administrative measures were aimed only at curbing investment in overheated sectors of the economy such as steel, aluminum and cement. From that time forward, the party's formal guiding principle became "macroeconomic regulation primarily though administrative regulation."

Following this ideology, all levels of government gradually increased their intervention levels and control over the microeconomy, but under the auspices of macroeconomic regulation. This increased the government's abilities and strength in resource allocation, effectively weakening the fundamentals of market-based resource allocation. A trend developed that reflected what Britain's Lord Acton once said: "Power tends to corrupt, and absolute power corrupts absolutely." As administrative power expanded, so did rent-seeking and corruption.

Political reforms also lagged. Deng delivered a famous speech in 1980 that called for a new wave of political reform. At the time, he was launching nationwide rural contracting reform. Six years later, he said it would be very difficult to effectively implement economic reforms unless China also adopted additional political reforms. But Deng's calls went unheeded. A new generation of leaders raised the political reform issue again after his death, at a memorial held in his honor. In 1997, during the 15th National Congress of the CPC, party leaders called for a thorough legal system under socialism. Five years later, during the 16th National Congress of the CPC, political reforms were advocated again. They even raised the issue of certain democratic reforms.
Still, very little progress has been made over the past decade. For example, 13 years passed before certain fundamental principles of a market economy, such as property rights and anti-trust legislation, finally appeared on the national agenda. A society that does not conform to basic, generally accepted legal principles with an independent, impartial judiciary will have trouble obtaining effective contract guarantees. Under these circumstances, those who participate in economic activity only need friends in local officialdom to safeguard property and ensure economic survival. And a lack of political reforms to complement economic reforms gave new impetus to rent-seeking.

Corruption spread rampantly. Independent research conducted since 1988 said property rents account for up to 30 percent of China's GDP, or up to 5 trillion yuan a year. This underscores the divide between the nation's rich and poor and result in China's high Gini coefficient.

**Reforms, Round Three**

The longer it takes for reforms to be properly implemented, the more potential for conflict between advocates of the old and new systems. Those with vested interests who were allowed to accumulate power and influence have strong motivation to thwart reforms that might damage their interests. China's central authorities do not consider retreat an option. Still, deeper reforms will require more force, as well as practical considerations.

A double-track pricing system can follow one of two development paths. One leads to a market economy based on rule of law. The other leads to crony capitalism. When market reforms are dramatically encouraged, as they were in the early 1990s when prices of certain commodities were opened to the market, and when rent-seeking is substantially deterred and corruption curbed, the public voices approval.

For example, at the turn of the century, when a large number of local enterprises following the Southern Jiangsu Model reformed by trimming operations, coastal economies began to develop rapidly. And when general population living standards rise, in spite of local injustice, satisfaction levels generally increase. On the contrary, when reforms are impeded or policies distorted -- as they were during implementation of a Stolypin-style privatization through cronyism -- corruption becomes rampant and the gap between rich and poor widens.

Two solutions are possible in the face of these circumstances. Those that support market and corresponding political reforms think inequity in Chinese society stems from market reforms that have not been fully implemented, and a long lag for political reform. They think some are not only unwilling relinquish power but, instead, are
actually increasing economic intervention and trying to suppress the market while engaging in rent-seeking behavior. They say rooting out this problem requires comprehensive economic and political reforms that eradicate the economic base for crony capitalism, while putting legal constraints on authority and increasing public supervision.

Still others have advocated a solution that takes the complete opposite approach, returning to the pre-1976 extreme leftist model of resource allocation. Old system supporters shifted blame for rampant corruption and the unfair resource allocation to market-oriented reforms.

This kind of debate has surfaced many times over the past 30 years. A focal point this time is the reform policy launched by the Third Plenary Session of the 11th CPC Central Committee. Defenders of the old system blame market reform for social problems such as corruption, unequal resource distribution, high medical bills, educational shortcomings, and even mining accidents. They propose turning back the clock and instituting a proletarian dictatorship.

This old-way position, whether the perspective is providing a "diagnosis" or "prescription," is fundamentally flawed. Take the gap between rich and poor as an example. Defenders of the old system claim supporters of market reform also support a wider gap between rich and poor, and that market reforms are the primary reasons for the gap's increase. But facts tell a different story. And concern over unequal wealth distribution is nothing new: China's income gap was a key issue for sociologists and economists who advocated reform in the early 1990s.

But why has the gap between rich and poor risen, and what should be done to resolve the problem? Defenders of the old system categorically assert that the problem was caused by market reforms, and hence they advocate aiming a spear at citizens who through hard work and skill managed to attain decent salaries, with the goal of narrowing differences that separate them from people at lower income levels.

Those who support resolving social problems through reform argue that unequal opportunity is at the root of the income gap problem. Since administrative units of the party and government have power to allocate resources, those close to this power can attain wealth quickly through rent-seeking. Supporters of reform also argue that the widening gap is caused in part by enterprises in certain industries with monopoly power. Based on this analysis, closing the gap between rich and poor could be accomplished by advancing market reforms, eliminating the basis for rent-seeking, breaking up monopolies, and ending corrupt practices that use government authority to do business.

Of course, income gaps occur even in a perfect market system because people's abilities vary. China's dualistic economy, which includes traditionally inefficient
farming and an advanced industrial-commercial network, creates an income gap that's more pronounced than under other economic structures.

To fight inequality, the government should take practical steps. The most important corrective measure would be to shoulder responsibility by establishing a social security system that provides basic necessities for low-income workers. The social security system China originally implemented to cover only state-owned entities was inherently flawed. For example, a free healthcare system covered only SOEs and administrative units of the party and the government. Most disbursements were limited to city residents, particularly leading party cadres and government officials. Ordinary workers, particularly farmers, lacked access to doctors and medicine.

After China started opening, the entire system collapsed until 1993, when reforms laid a new framework for nationwide social security. From a modern perspective, this framework is generally feasible. If it were further improved during implementation, the plan could provide an effective safety net. However, it's still not complete. And due to various vested interests, negative attitudes and even outright resistance toward the plan are common. SOE employee "empty account" compensation issues also stand in the way.

Those who misdiagnose the income gap and other social ills may be laying groundwork for even more harm by calling for a return to a total dictatorship. The source of crony capitalism in China is the unrestrained power held by certain factions that lets them intervene in economic activity and allocate resources. Supporters of the old economy want to increase SOE monopoly power and strengthen government's dictatorial power. But wouldn't that provide a systematic basis for an environment open to more corruption, making goals such as income equality impossible to reach?

Supporters of the old system who use nationalism and populism as political tools have had some success in debates over healthcare, education, housing and SOE reform. They've roused emotion, sometimes deceiving people with tricks and ideology. However, a glance at history exposes their strategy. They are proposing a return to an old system that brought immense hardship to Chinese people. Those with reservations about specific methods employed during the reform and opening era should take a rational look at the situation and support comprehensive economic and political reform.

Party and administrative officials have already clearly expressed their positions. In March 2006, in a speech to the Shanghai delegation of the National People's Congress, President Hu Jintao said reform efforts would not abate. He called for continuing to improve socialism with Chinese characteristics that reflects the basic functions of a market-based allocation of resources. And in October 2007, at the 17th National Congress of the CPC, a Central Committee report addressed "which flag to raise and which road to take" while stating, "China's reform and opening up is in line with party and popular sentiments. Now, the trend is conforming to the times. Our course is right,
the results and achievements impossible to deny, and there will be no halting or retreating."

Whether China's economy can continue down this glorious path for the next 30 years will depend on how well the nation deals with new challenges.

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