

CHINESE ECONOMIC GROWTH: EXPLANATIONS AND THE TASKS AHEAD

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1. INTRODUCTION

China's market-oriented reforms have produced high economic growth and dramatic structural transformation. The average annual GDP growth rate for 1979-93 was 9.3 percent. In the same period, the proportion of the labor force engaged in agriculture dropped from 71 percent to 56 percent, and trade (exports plus imports) rose from 10 percent of GNP to 36 percent. This rapid growth and transformation of the economy has resulted in what must be one of the most successful poverty alleviation programs in the twentieth century. The incidence of absolute poverty declined dramatically in the rural area, from 33 percent in 1978 to 12 percent in 1990.¹

China's extraordinary growth performance should not, however, take attention away from many deep problems that China will face in the coming years. While China's state sector is too small to drag down the non-state sector, it still imposes large financial and allocational costs of the economy. China's underdeveloped legal system will be more of a drag on the economy as the complexity of economic life increases, unless legal reform can keep pace with economic growth. Property forms that have worked in the past fifteen years, such as the township-and-village enterprises (TVEs), are likely to be less effective in the future, especially as village-based life is supplanted by a highly mobile, non-agricultural population. Political legitimacy will also be under serious stress. Growing income

¹ Table 2.1 in World Bank (1992). Poverty is largely a rural phenomenon. Absolute poverty in the urban area was 2 percent in 1981 and 0.4 percent in 1990.

inequalities across regions will raise demands for compensatory policies from the center, which will prove hard to satisfy. At the same time, continuing corruption and misuse of state assets will further undermine the public support for the existing political institutions. These political problems will play out against a backdrop of continuing serious pressures on the state budget, arising from low tax revenues and losses of the state-owned enterprises.

These issues are taken up in the following sections. Section 2 outlines the gradual (dual-track) reform program that was implemented after 1978. We attribute the gradual reform strategy to the logic of political compromise, and the complexity of political and economic change in a country of more than one billion people, rather than to the logic of experimentation as sometimes asserted in the official rhetoric. Sections 3 and 4 identify the main sources of growth. We put the basis of China's impressive economic performance in the context of a liberalizing, surplus-labor economy. Section 5 discusses the major remaining tasks for economic reform in China.

2. THE CONTOURS OF CHINESE ECONOMIC POLICY

The reform strategy that has been implemented is best described as the dual-track approach: the co-existence of a market track and a plan track. The dual-track approach pervades almost every aspect of policy-making: sectoral reform, price deregulation, enterprise restructuring, regional development, trade promotion, foreign exchange management, central-local fiscal arrangements and domestic currency issuance. We outline below three important areas where dual-track reform has been implemented.

Dual-track production and pricing

The dual-track approach started at the end of 1978 with rapid and comprehensive liberalization

of the agricultural sector. The agriculture communes were disbanded by distributing the land to the peasants, and granting 15-year leases on the land, with the leases being freely tradeable. State procurement prices for agricultural products were raised, and free markets for agricultural products were allowed. Some production incentives (notably, profit-retention and bonus) were introduced for some classes of secondary and tertiary activities during the first phase of reform.

The impressive growth of the agricultural sector upon marketization led to broader liberalization of the secondary and tertiary sectors in mid-1984. The state-owned enterprises (SOEs), located mainly in urban areas, were liberalized by devolving to them some decision-making power from the supervising industrial bureaus. The state procurement quotas for consumer goods were reduced to be much lower than for producer goods.

The typical process of dual-price transition is as follows: (1) opening the free market while keeping state supply unchanged at the (lower) plan price; and (2) adjusting the plan price incrementally over time to approach the market price. The supply offered at the plan prices is normally fixed by quota, if not reduced, over time. Generally, no "shock" is observed when convergence of the two prices occurs.

Farmers now enjoy a large range of production freedom, only 5 percent of their production in 1993 were set by the state plan. The proportion of planned production of total industrial output value has been reduced from over 90% in 1978 to 5% in 1993.

Dual-track ownership structure

The most important dual-track component has been the reform of the ownership structure. The ownership reform started when the collective "Commune" system was replaced by household farming. This made a major part of agriculture, which accounted for over 30 percent of GDP at that time, a de

facto private economic activity.

Since 1984, there has been steady relaxation of the regulations governing the registration and supervision of private enterprises and community-owned enterprises (COEs), with the latter vastly more favored. The bulk of COEs are situated in the rural areas, and these rural COEs are better known as township and village enterprises (TVEs).²

The explosive growth of the non-state sector has caused the share of industrial output produced by SOEs to fall from 78 percent in 1978 to 69 percent in 1984, and then to 34 percent in 1994.³ It must be emphasized, however, that the SOE sector is not withering away, as suggested in claims of China having "grown out of the plan." The SOE sector has actually retained its relative standing in employment: 18 percent of the 1978 and 1993 labor force. There were 35 million more SOE workers in 1993 than in 1978.

Dual-track regional development

In 1980, four southern coastal cities (Shantou, Shenzhen, Xiamen and Zhuhai) were designated "Special Economic Zones" (SEZs). The SEZs were given autonomy to experiment with new institutions and reform, e.g. exemptions from many of the regulations that govern foreign investment. The resulting phenomenal growth of the SEZs spurred other regions to demand economic liberalization as well. An additional 20 cities were subsequently approved as "economic and technologic development districts" (ETDDs), which had some of the privileges of the SEZs. Hainan province became the fifth SEZ in 1988.

² Given that the unleashing of the rural TVEs brought great dynamism to the economy, it is hence not right to characterize the post-1984 reforms, as some have done, as reforms of the urban sector.

³ Strictly speaking, data before 1984 are not comparable because prior to 1984 much of the industrial output by the communes were categorized as agricultural output.

The Political Necessity for a Gradual Reform Strategy

Gradualism in the form of dual-track reform is as much the result of political deadlock or compromises within the Communist Party of China (CPC) between the hardliners and the reformers, and the general lack of consensus in the society at large, as the result of a particular theory of reform. The hardliners have enunciated the "bird cage economy" doctrine. In the conception of its originator, Chen Yun, the central plan is the cage and the bird is the economy. The premise is that without central planning, production would be in chaos, i.e. without the cage, the bird will fly away. The amount of market activities that is to be tolerated to keep the economy working is analogous to the amount that the cage needs to be swung to create the illusion of greater space that is required to keep the bird happy. The reformers, on the other hand, believe that only a market economy will promote long-term economic development.

In short, "muddling through" has not been a strategy, as have been claimed, so much as a result of the lack of political consensus. With these differences in views, it is not surprising that the CPC has continually altered its stated goals for economic management. Partly these changes reflect the results of experience under the reforms, and partly they reflect the shifting balance of power between competing factions, with competing conceptions of the economy. This point is most clearly seen in the evolution of CPC's desired economic mechanism, which went from "a planned economy based on the law of exchange value" before 1979, to a "planned economy that is supplemented by market regulations" in 1979-1984, to a "planned commodity economy" in the 1985-88 period, and (after two more changes) to "a socialist market economy with Chinese characteristics" in 1992.⁴ The 1992

⁴ The "law of exchange value" is from the Marxian (labor-based) theory of value, and "commodity economy" refers to an economy in the early stage of economic development where the emphasis should be on increasing production rather than on equality, so that concessions to market incentives may be necessary.

statement is very significant because the word "plan" was finally dropped from official rhetoric. The phrase "socialism with Chinese characteristics" is an implicit denial of the universality of socialism, and hence a rejection of the planned economies of the Soviet bloc where state ownership of production units is the norm.

The new official vision of China's economy in 1992 was no doubt partly shaped by the demise of the Communist Party of the Soviet Union in 1991. The shock of the collapse of the Soviet Union enabled the Chinese reformers to re-start the economic liberalization that had been suspended by the hardliners which dominated policy-making after the unfortunate 1989 Tiananmen shooting. The process of marketization and internationalization of the Chinese economy accelerated because the Soviet experience has convinced the leadership of the CPC that "centralized control, enforced egalitarianism, international isolation and ideological dogmatism" was suicidal; Garver (1993, pp.26). CPC has even gone as far as allowing some degree of privatization of SOEs. A notable recent example of significant privatization is Zhucheng in Shandong province, where many "state firms are being leased to entrepreneurs, turned into shareholding companies and, in the case of one marginal concern, even given away."⁵

3. THE CONTOURS OF CHINESE ECONOMIC GROWTH

There are two phases to China's economic growth, and the turning point corresponds to, one, the policy regime change toward accelerating reforms in the nonagriculture sectors, and, two, the emergence of industry as the undisputed primary engine of growth. The sectoral contributions to GDP growth in the 1979-93 period, and in two subperiods, 1979-84 and 1985-93 are given below.

⁵ "China City Turns into a Prototype for Privatization," Wall Street Journal, June 10, 1996.

Share of Contribution to GDP Growth Rate by Sector,
and by Ownership in the Industrial Sector

(in percentage points, each column sums to 100)

	Growth in 1979-93	Growth in 1979-84	Growth in 1985-93
primary sector	16.5	31.8	11.6
industrial SOEs	13.8	20.3	11.7
industrial COEs	25.0	12.8	28.9
individual-owned industrial enterprises	5.9	0.2	7.7
other ownership forms of industrial enterprises	6.9	0.8	8.9
construction sector	5.7	5.2	5.9
tertiary sector	26.2	28.9	25.3
TOTAL	100.0	100.0	100.0

(Calculated from series that have been consistently re-based on 1993 prices.)

Agriculture was a leading growth sector in the 1979-84 period. Agriculture's contribution to aggregate output expansion almost matched that of industry, 32 percentage points and 34 percentage points respectively.

In the 1985-93 subperiod, industry accounted for 57.5 percent of the increase in output; and the tertiary sector greatly out-stripped the primary sector in terms of contribution, 25 percent versus 12 percent. The biggest contributor to GDP growth is the industrial COE sector, 29 percentage points. Industrial individual-owned enterprises accounted for 8 percentage points of the aggregate output growth.

The growth performance of the 1985-93 subperiod may be a better guide (than that of the entire period) to understanding the future growth prospects of China. This is because the agricultural sector is unlikely to become a major growth pole again as in the 1979-84 period.

We note that the official GDP growth rates are exaggerated, and possibly significantly so. The major causes of the exaggeration are:

- * the pervasive reporting by COEs of nominal output value as real output value;
- * the incentive for officials at the local industrial bureaus to exaggerate output growth in order to enhance their career advancements;
- * the procedure for reporting the base-year values of new product lines overstates them; and
- * the inconsistent use of base-year prices.⁶

The by-product of all these tendencies to exaggerate the growth of real gross output is that the implicit deflators for the industrial output of SOEs and COEs consistently rose less than the factory-gate price index of industrial output, which is based on surveys of the prices (plan price and market price) received by a sample of industrial SOEs, mostly medium and large, for their products. In the 1990-93 period, the industrial COE output deflator rose 6 percent while the industrial SOE output deflator rose 35 percent, the factory-gate price index of industrial output rose 41 percent, and the consumer price index rose 26 percent.

If the factory-gate price index were correct, then the official growth rate of the industrial sector in 1993 overstated the actual growth rate by 10 percentage points. Because the industrial sector was the biggest contributor to GDP growth, the re-valuation of real industrial output by factory-gate prices would lower the 1993 official GDP growth rate from 13.4 percent to 8.9 percent. The sub-period GDP growth rates after the adjustments for base year changes and inadequate deflation of industrial output are:

⁶ For details, see Woo (1996).

GDP Growth Rates With Different Deflations of Industrial Output

	<u>1979-1984</u>	<u>1985-1993</u>
	(in percent)	
official data	8.9	9.7
consistent base year (1990 prices)	8.8	9.4
consistent base year (1990 prices) with re-valuation of industrial output using factory-gate price index	8.9	7.5

Given the many problems with the reliability of Chinese data, the correct way to look at the preceding GDP growth rates (and the subsequent estimates of total factor productivity, TFP, growth rates) is to regard them as the upper and lower ends of the respective plausible ranges within which the actual GDP (and TFP) growth rates lie. The upper end of the estimates on GDP growth is given by the official data and the lower end of the estimates is calculated by re-valuing industry output with the factory-gate price index.⁷

It is important to stress however that the conventional view regarding the sources of growth in the 1985-93 period remains unchanged after re-valuing industrial output with factory-gate prices. The industrial sector remained the chief engine of growth, and the non-state sector was still in the driver

⁷ One important issue that needs to be clarified here is the possibility of a relationship between the estimated GDP level and the estimated GDP growth rate. As is well-known, the actual level of GDP may be understated by official data. The point that must be understood is that the understatement of the level does not automatically mean that the official growth rate is also understated. Unless it can be shown that the unmeasured part of GDP has been growing consistently faster than the measured part, one could not conclude that the official growth rate is an understatement. One could in fact argue the opposite: the existence of unmeasured economic activities means that an improving statistical reporting system would begin to count them, treating the existing activities as new activities, and hence exaggerate the growth rate. So an understated level of GDP is likely to produce an overstated rate of GDP growth as data reporting improves over time.

seat.⁸

The leading role of the industry sector in GDP growth since 1978 (even more so since 1984) places China's economic growth within the context of traditional economic development. The unusually large contribution of the tertiary sector to China's growth places China's experience within the context of economic transition from traditional central planning. Central planning has traditionally regarded service activities as "unproductive",⁹ and hence has suppressed them. The rapid development of the service sector after 1978 reflects its relative underdevelopment because of its prior suppression.

The Mechanics of Growth

Woo (1996) conducted a growth accounting exercise based on the three sectors -- primary, secondary (industry and construction) and tertiary -- as defined by Chinese statistics. Each sector is assumed to be characterized by a Cobb-Douglas production function, and the result is:

$$Y = \sum (\alpha_i x_i^{\beta_i} z_i^{(1-\beta_i)}) L^{\beta_i} K^{(1-\beta_i)}$$

where

- Y = GDP
- L = total labor force
- K = total capital stock
- w_i = sector i's share of GDP
- x_i = sector i's share of labor force
- z_i = sector i's share of capital stock
- sector 1 = primary sector (agriculture, forestry and fishing),
- sector 2 = secondary sector (industry and construction)
- sector 3 = tertiary sector.

GDP growth can be decomposed into portions that are due to capital accumulation, labor force

⁸ Industry now accounted for 47 percent of the output expansion in 1985-93, the tertiary sector for 31 percent and the primary sector for 14 percent.

⁹ Most service activities are not counted in Net Material Product, the aggregate income measure used in socialist economies.

growth, and total factor productivity (TFP) growth:

$$(dY/Y) = (dL/L)\sum w_i\beta_i + (dK/K)\sum w_i(1-\beta_i) + \sum w_i\beta_i(dx_i/x_i) + \sum w_i(d\alpha_i/\alpha_i) + \sum w_i(1-\beta_i)(dz_i/z_i)$$

where TFP Growth = $\sum w_i\beta_i(dx_i/x_i) + \sum w_i(d\alpha_i/\alpha_i) + \sum w_i(1-\beta_i)(dz_i/z_i)$

TFP growth is in turn partitioned into, what we call here, labor reallocation effect and net TFP growth:

$$\text{labor reallocation effect} = \sum w_i\beta_i(dx_i/x_i)$$

$$\text{net TFP growth} = \sum w_i(d\alpha_i/\alpha_i) + \sum w_i(1-\beta_i)(dz_i/z_i)$$

Net TFP growth is the residual that contains technological improvements.

Labor reallocation is singled out for attention because the bulk of the Chinese labor force is peasant farmers, a third of whom lived below the absolute poverty line in 1978. We have argued in Sachs and Woo (1994) that this "surplus labor" feature¹⁰ has made China's transition from centrally planning fundamentally different from the transition of Central and Eastern Europe and the former Soviet Union (CEEFSU). Specifically, this means that in China the shift of labor away from agriculture toward industry and services increases aggregate output because the marginal product of labor (MPL) in the primary sector is lower than the respective MPLs in the secondary and service sectors.¹¹ In short, the marketization of a centrally-planned economy means normal economic development for China but structural adjustment for a CEEFSU country.

Given the unreliability of data on the sectoral distribution of capital stock, upon which these estimates of sectoral β 's were based, we drew upon the production function literature on China to

¹⁰ Agence France Press (December 7, 1993) reported the Agriculture Minister Liu Jiang as saying that there were 150 million excess farm workers (out of a rural labor force of 450 million).

¹¹ Chow (1993) found the marginal value product of labor in 1978 to be 63 yuan in agriculture, 1027 yuan in industry, 452 yuan in construction, 739 yuan in transportation and 1809 yuan in commerce. Figures are expressed in 1952 output values.

generate a range of TFP growth rates by using different values for a common β across the three sectors; specifically, $\beta = 0.4, 0.5,$ and 0.6 . The official data on sectoral distribution of labor should be used critically. The official estimate of labor in agriculture is based on registered residency status, it is an overstatement because of illegal rural migration, especially to coastal TVEs. The official estimate of the size of illegal migration is 80 million and the World Bank's highest estimate is 150 million. The official estimate (80 million) does not include the 20 million people who migrate within their home districts.¹² In our calculations, we assume illegal rural migration to be 100 million since 1984, with 60 percent of the migrants ending up in industrial jobs.¹³

To summarize the range of estimates, the official growth rates could be reasonably decomposed to:

(in percentage points per annum)	<u>1979-93</u>	<u>1985-1993</u>
official growth rate	9.3	9.7
inconsistent use of base years	0.2	0.3
overstatement of industrial output	0.5 to 0.7	0.9 to 1.2
capital accumulation	4.9	5.5
labor force growth	1.3	1.1
reallocation of labor from agriculture	1.1	1.3
net TFP growth	1.1 to 1.3	0.3 to 0.6

¹² Far Eastern Economic Review, "Irresistible Force," April 4, 1996. Newsweek, "Crime: You Die, I Live," July 22, 1996, reported an estimate of 120 million.

¹³ The sum of the official estimate of 80 million who moved out of home district and the 20 million who moved within their home districts.

We emphasize that the above estimates of TFP growth, labor allocation effect and net TFP growth should be considered together with the range of estimates associated them; see Woo (1996) for details.

There are two robust key findings from the detailed analysis. The first robust finding is that net TFP growth was lower in the 1985-93 subperiod than in the 1979-84 subperiod. This suggests that a part of the TFP growth unleashed by the 1978 reforms was a one-time recovery in efficiency from the decade-long Cultural Revolution and from the over-regulation of the economy by central planning. The unfortunate implication for future Chinese growth is that this one-time recovery in efficiency was not limited to the agricultural sector, it was also present in the industrial sector.

The second robust result from the growth accounting exercise is that the reallocation of labor from agriculture accounted for much of the observed TFP growth, perhaps more than half. This labor reallocation effect was much higher in the 1985-93 subperiod. To indicate how large this effect is, we note that Denison (1974, pp.127) estimated that labor reallocation from the farm sector accounted for only 13 percent of TFP growth in the United States in the 1948-69 period.¹⁴ The large labor allocation effect in China reflects the existence of large amount of labor employed in low-productivity agriculture and the success of the post-1978 Chinese reforms in creating higher-productivity jobs in the industry and service sectors.

4. EXPLAINING THE GROWTH

The high rate of capital accumulation (the biggest contributor to Chinese growth) has its basis in the liberalization of a labor-surplus economy that has a high saving rate. Investment is highly

¹⁴ U.S. national income grew 3.85 percent annually in the 1948-69 period, and TFP growth was 1.75 percent; with labor reallocation from the farm sector accounting for 0.23 percentage points.

profitable because the surplus labor prevented the real wage from rising significantly and the large pool of domestic saving prevented the interest rate from rising. The importance of the latter is seen in that household saving is about 23 percent of disposable income in China versus 21 percent in Japan, 18 percent for Taiwan, 16 percent for Belgium, 13 percent for West Germany and 8 percent for the United States (World Bank, 1990, Table 4.9).

It should be noted that China's high household saving rate has helped to stabilize the economy beside enabling a high rate of capital accumulation. It reduced inflation in the Chinese economy through two channels. First, the flow of savings through the banks reduced the need to print money to meet the excessive resource demand of the SOE sector. Second, as money was (until recently) the only form of financial saving in China, the high saving rate meant an increasing demand for money, hence dampening inflation pressure. This inflation-dampening effect can be seen in the rise of the M2 to GNP ratio from 38 percent in 1979 to 106 percent in 1992.

In addition to the "advantages of backwardness" in economic structure and the high saving rate, there are several other factors that have contributed to China's impressive growth performance. The most important of these other factors is China's integration into the global economy. This factor operates through four channels. First, the access to international markets for labor-intensive manufactured goods accelerated the movement of labor out of low-productivity agriculture into high-productivity industry. Second, China could now buy modern technology (some of which were previously denied to China). Third, foreign direct investments increased the capital stock, transferred new technology, made available global distribution networks, and introduced domestic firms to more efficient management techniques. Fourth, the competition from international trade forced Chinese enterprises to be more efficient and innovative.

The second supplementary factor in China's reform success is that China's reforms did not start

in a situation with a severe macroeconomic crisis and a severe external debt crisis that required the implementation of an austerity program. China has been developing its economy by having the TVEs employ the idle agriculture labor, while Poland and Russia have been attempting to tame inflation and restructure their fully-employed economies simultaneously.

A third supplementary factor is the two disastrous leftist campaigns, the Great Leap Forward (1958-62) and the Cultural Revolution (1966-76), that undermined belief in Marxist dogmas, weakened the state's administrative capacity, and discredited central planning. The Great Leap Forward program of crash industrialization starved 30 million to death in the 1958-61 period, and the Cultural Revolution effort to build the new socialist man purged 60 percent of party officials. The legacy of these two disasters enabled Deng Xiaoping to quickly transfer a significant amount of economic policy-making power (which translated into a transfer of economic and political resources) to the provinces when he returned to power in 1978. The central ministerial and party apparatus were too politically exhausted and too discredited to resist his decentralization.

This ending of Beijing's stranglehold over political power has been fundamental to the continuation of economic reforms. When the conservatives sought to re-impose a Stalinist central planning economy in the immediate aftermath of the Tiananmen incident in 1989, the provincial representatives were strong enough to repel the recidivist tendency toward central planning. Furthermore, it was the mobilization of this new decentralized political power by Deng Xiaoping after the collapse of the Soviet Union that forced the conservative faction to accept the new vision of a socialist market economy.

A fourth supplementary factor is that central planning in China was always much shallower than in CEEFSU. The Soviet central plan controlled 25 million commodities whereas the Chinese central plan controlled only 1200 commodities (Qian and Xu, 1993). Furthermore, the breakdown of

the national distribution system in the Cultural Revolution decade forced local authorities to small and medium industrial enterprises to meet local demand.

The existence of family ties between the mainland Chinese and the overseas Chinese supplementary factor. The explosive growth of the Special Economic Zones (SEZs) in south is caused by the wholesale movement of labor-intensive industries from Hong Kong and Taiwan were losing their comparative advantage in these industries. China was closer, wages were low, language difficulties were non-existent, compared to the alternative sites in Southeast Asia. Managers could commute daily from Hong Kong to supervise their factories in Shenzhen. The family connections greatly reduced the transaction costs of the investment by providing reliable local supervisors, inside information on the enforcement of regulations, and contacts with the local authorities.

Of all the factors identified as important causes of China's achievements in the 1978-95 period, only the high saving rate and the globalization of China's economy could be considered lessons for economic reforms. The other factors (all being initial conditions and structural features) are rather specific to China's circumstances.

China's Economic Performance in Comparative Perspective

The experience of Vietnam confirms that it is China's structural conditions, rather than its gradual reform process, that mainly account for its superior growth performance vis-a-vis the CEEFS countries. During 1985-88, Vietnam implemented a gradual reform strategy that did not address serious macroeconomic imbalances. The program failed: inflation accelerated while growth and trade performance remained unchanged. In 1989, Vietnam enacted an Eastern-European style "big bang," including price liberalization, a 450 percent devaluation to unify the exchange market, and sharply

tightened credit policy. The collective farms were returned to family farms with long-term leases. Growth accelerated, inflation ended, agricultural productivity soared, and small, non-state enterprises proliferated.

The "big bang" did not cause an output decline in Vietnam as in Eastern Europe. The difference lies of course in Vietnam's economic structure in 1988. As an overwhelmingly agricultural economy, Vietnam enjoyed the same gains as China from the flow of peasants to the non-state, non-agricultural sector. Strong market-oriented reforms (macroeconomic stabilization and liberalization), not gradualism per se, tend to accelerate this shift.

Economic development in China, and Vietnam since 1978 actually fit quite well with the general East Asian development pattern. Japanese, Malaysian, Taiwanese and Thai economic growth have also been described by a two-sector model focussing on the flow of workers from agriculture to industry. The resulting export of waves of labor-intensive exports in line with the product cycle theory has been poetically described as the "flying geese" pattern of industrialization.

The high labor reallocation effect in China resembles that seen in Japan in the mid-1950s when the trend growth rate accelerated as Japan's integration into the global economy intensified. Ohkawa and Rosovsky (1973, pp.116) found the contribution to aggregate output growth from the reallocation of labor from agriculture to be:

<u>period</u>	<u>labor reallocation effect (in percentage points per year)</u>
1905-19	0.63
1919-31	0.25
1931-38	0.61
1952-55	0.76
1955-61	1.46

Given the East Asian growth experience and China's large pool of low-productivity rural labor, we regard the labor-allocation effect of 1.2 percentage points to be the dependable contribution to China's TFP growth in the medium run.

5. FUTURE CHALLENGES

Two points about China's gradual reform program deserves re-emphasis. The first is that the dual-track approach worked in China, but not in Jaruzelski's Poland and Gorbachev's Russia, because of China's vast rural hinterland. The TVEs and other non-state enterprises were able to grow without sharp rises in marginal costs and without the need to force reductions of employment in the SOEs because of the existence of surplus agricultural workers. The second is that China's gradualism is an "easy-to-hard" reform sequence. It began with the relatively easier problems and has left the hard problems until later. In contrast, the more radical approach in parts of CEEFSU have tackled the hardest problems -- including ownership transformation, structural reforms, and political democratization -- at the beginning.

China's rapid growth can continue as long as the non-state sector remains dynamic, and essentially unhindered by financial losses or problems thrown up by the SOE sector. Dynamism of the non-state sector, however, is likely to require continuing reforms in that sector, such as the extension of truly private ownership instead of collective ownership. Moreover, state enterprise reforms will have to be deepened in the future, to include privatization and structural adjustment, if losses in that sector are to be kept limited.

We would enumerate the main economic reform challenges as follows: (1) restructuring of TVE ownership, to encourage private, transferable ownership rights; (2) the restructuring of the SOE

sector, especially to encourage private, corporate forms of ownership; (3) the modernization of the fiscal system and of federal-local fiscal relationships; (4) the development of a non-state financial sector; (5) the elimination of policies that aggravate regional inequality; and (6) the establishment of market-supporting institutions and commercial law.

We will conclude with brief comments on these six tasks.

Ownership Transformation of the TVEs

China would be ill-advised to continue to base its rural industrialization on collective ownership. This is especially true as geographical mobility within China rises, so that the village no longer represents a long-term stable base for collective ownership. The problems for the future can be divided, in the broadest sense, into two parts. First, what kinds of ownership should be encouraged for new rural enterprises? Second, what should be done about the ownership structure of existing TVEs?

The main task for future enterprises is to ensure that normal forms of private ownership -- including self-proprietorships, partnerships, privately held corporations, and publicly held corporations -- are all possible in the rural economy without incurring excessive transactions costs. Even if collective ownership by the community remains one important option for the future, it is also necessary that truly private ownership be allowed and fostered by the legal system. The new company law that went into effect on July 1, 1994, is an important step forward in this task.

The second problem, concerning the existing TVEs, is more complicated. Throughout China, existing TVEs are suffering from the lack of clarify of property rights, and there are many spontaneous attempts throughout the country to clarify the ownership of the TVEs. In almost all cases, there are at least three claimants, or stakeholders, that are insisting on their ownership rights: local governments, enterprise managers and workers. The situation is further complicated by the vast variety of ways that

individual TVEs actually got started.

As a general point, China might benefit from one important aspect of the Eastern European and Russian privatization experience when it considers the ownership question of the existing TVEs. In the most successful privatization programs -- such as in the Czech Republic -- one of the key strategies was to give each enterprise some range of choices with respect to future ownership change. In any successful ownership transformation of the existing TVEs, it will be important, and probably inevitable, to give choices to the community. The community, and perhaps workers, could vote among a menu of possible legal options, including preservation of the collective structure, or privatization among the main stakeholders.

Restructuring the SOE sector

The reform of the SOE sector has been disappointing. TFP growth in the SOE sector is at best only half of that of TVEs. There is in fact serious doubt that SOEs' TFP growth after 1984 is actually greater than zero!¹⁵

If we go beyond technical efficiency as the sole criteria of successful reform, then China's SOE reform record look even worse. Overall profitability of the SOE sector has been declining, and the number of loss-making SOEs are increasing. This poor financial performance was most vividly seen in 1992 when output grew 13 percent, and yet two-thirds of Chinese SOEs were running losses in a boom year! The overall profits of the SOE sector actually turned negative in the first quarter of 1996. Some observers have suggested that the primary reason for the profit decline in the SOEs is the expansion of competition by collectively-owned enterprises allowed by the economic reforms. The problem with

¹⁵ See debate between Woo, Fan, Hai, and Jin (1993 and 1994) and Jefferson, Rawski and Zheng (1994).

this explanation is that the fall in SOE profits occurred across the board, even in heavy industries with negligible new entry by non-state firms. The more likely reason for the decline in profitability is that the decentralized reforms of devolving operational autonomy to the SOEs have enabled the SOE personnel to appropriate for themselves the profits that should have been repatriated to the state.¹⁶

The CEEFSU experience prior to 1990 suggests that without deeper reforms of the SOE sector, the financial demands of loss-making state enterprises will continue to threaten macroeconomic stability. In our view, it will be highly desirable for China to push forward to privatization of the SOE sector, and liquidation of the unredeemable loss-making enterprises. Widespread privatization, perhaps under a different rubric, is not as far-fetched as it might seem. There are currently some 25 property rights exchanges in China where state assets are sold to the public.¹⁷ Reports indicate that there are around 150 unofficial property rights exchanges in smaller cities, and the operations of these unofficial exchanges are dependent on the ideological climate.

Modernization of the fiscal system

The 1994 tax reform has not reversed the decline in revenue as hoped. Tax collection in 1994 was 12.4 percent of GDP, down from 13.8 percent in 1993. While the continued financial weakening of the SOE sector was an important reason for the decline, it appeared that many branches of the new National Tax Service had not really divorced themselves from the influence of the local governments, which desire to retain the funds for local development.

The tax system has continued to be badly administered, hence allowing tax fraud and tax

¹⁶ See Fan, Hai and Woo (1996).

¹⁷ "Property rights exchanges on increase," China Daily, February 19, 1994.

evasion. Under the new VAT system, producers receive VAT refunds on their exports. However, the large amount of false export claims has resulted in over-payment of VAT refunds. The government has suspended the VAT refunds for exports. Local governments are continuing to give illegal tax exemptions, such that the actual customs revenue (which goes to the central government) is only 6 percent of total import value, despite an average tariff rate of over 30 percent.¹⁸

It is imperative that tax administration be improved and that central-local fiscal relations be better institutionalized to yield independent tax authority to the central and local governments. Otherwise, the state would not be able to finance the infrastructure investments required to prevent bottlenecks that would slow economic growth.

Development of the non-state financial sector

Presently, the state banks dwarf all other financial institutions as sources of funds, and SOEs receive about 70 percent of total domestic credit. Recognizing the gross inefficiencies of the state banks, the government has ordered them to commercialize their operations. If the government can actually allow the state banks to do so despite the worsening financial performance of the SOEs, more capital would be channelled to the more efficient non-state enterprises, a desirable outcome.

Both the transformation of the state banks and the greater access to investment funds by the non-state would be achieved faster if the government would unleash competition by legalizing non-state financial institutions. The private banks would compete directly against the state banks; and the private nonbank financial institutions, by deepening the equity and bond markets, would create alternative sources of investment funds. Another desirable by-product of the competition from the

¹⁸ This low realized tariff rate also reflects the immense amount of export-processing activities where the import of the raw inputs for the assembly operations entered tariff-free.

non-state financial institutions is that it would be more difficult (costly) for the government to impose many non-economic objectives on the state banks.

Given the grave financial crisis that state-managed pension schemes have caused in many developed countries, China should avoid this future financial trap by allowing the establishment of private pension funds. Concretely, the government should not expand the existing state-managed pension schemes to cover non-state employees. The present virtual monopoly status of the People's Insurance Company of China in providing social insurance to non-state employees is hard to justify.

Elimination of policies that aggravate regional inequalities

Recently announced plans include giving the backward interior provinces the same preferential trade and investment enjoyed by the coastal provinces, and eliminating some of the special tax benefits enjoyed by the coastal areas. These measures should help to ameliorate the growing regional inequalities of the past decade, though the coastal regions will continue to benefit from an inherent geographical advantage in participating in world trade. It is also important to end price controls on grain prices for farmers, and to provide more support for social infrastructure in the rural areas.

Deepening of market-supporting institutions

The rule of law is an absolute necessity for the establishment of a system of property rights, and an independent judiciary body is required for objective adjudication of disputes. Furthermore, regulatory institutions to supervise the financial markets are important in maintaining the integrity of these markets, and hence the public confidence in them. The state should focus on delivering social services that markets usually provide inadequately, if at all e.g. welfare, education (especially in rural areas), and health-care to the indigent. The correction of market failures like those above will both

improve the working of a market economy and strengthen its political foundations.

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