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Rethinking thirty years of reform in China

Implications for economic performance

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Economic achievement after 30 years of reform

After three decades of economic reform, beginning in 1978, China has transformed itself from a centrally planned economy to a market economy. Prices for most commodities have been liberalised. The private sector, including private enterprises, shareholding companies and foreign-funded enterprises, has become the dominant part of the economy. Although the government is still playing an important role in the economy, the overall command system was abolished long ago.

During this period (1978–2007), the gross domestic product (GDP) growth rate in China was maintained at an average of 9.8 per cent annually—3.7 percentage points higher than that of the pre-reform period (1952–78) under the centrally planned regime. GDP in constant prices has increased by 14.8 times during the reform period, and achieved US\$3,283 billion in 2007 by the yearly average exchange rate of CNY7.6 for US\$1 (NBS various years; also below unless otherwise referenced). The size of the Chinese economy overtook Russia in 1992, Canada in 1993, Italy in 2000, France in 2005 and the United Kingdom in 2006, becoming the world's fourth largest in 2006. It is likely to surpass Germany in 2008. According to the purchasing power parity (PPP) measure of the World Bank, the Chinese economy is already the second largest after the United States (World Bank various years).

Due to its huge population size, China's GDP per capita is still low—only US\$2,456 in 2007—although it is 10.8 times what it was in 1978. Using different PPP measures (for example, World Bank 2008), this per capita level could be expanded three to four times.

One of the most significant improvements during the reform period was a dramatic reduction in poverty levels. In 1978, 250 million rural people were living in poverty, according to the national poverty standard using constant prices. This figure reduced to 15 million in 2007. By the World Bank's higher standard of those living on 'one dollar a day', rural poverty in China reduced from 31.5 per cent in 1990 to 8.9 per cent of the population in 2005 (Gill et al. 2007).

China and Russia—two large countries and former centrally planned economies—shared many similarities before their reforms, but they adopted different reform methods and achieved very different results. In particular, there was a striking contrast in the economic performance of the two countries during their reform periods.

China introduced a family-based Household Responsibility System (HRS) in its agricultural sector and decentralised its central planning system at the beginning of its reform. Price control was gradually released. The non-state enterprise sector was encouraged to develop, and market competition gradually became the dominant mechanism in the economy during a long period of transition. In the first decade of reform, from 1978 to 1988, the size of the Chinese economy in real terms expanded by 2.6 times. The annual GDP growth rate during this period was 10 per cent. Urban and rural household income per capita in constant prices increased by 1.82 and 2.11 times, respectively. The rural population living in poverty was reduced by 60 per cent.

In Russia, some similar reform measures were adopted in the late 1980s, but were soon replaced by radical 'shock therapy' in the early 1990s. In 1992, price control was removed entirely and central planning was abolished. Most state-owned enterprises were privatised in 1992 and subsequent years. If we regard the period 1990–2000 as the first decade of the reform period in Russia, GDP dropped by nearly 40 per cent—an annual decrease of 4.7 per cent. There was also hyperinflation and a dramatic reduction of people's incomes during this period.

Angus Maddison (2007) compared Chinese and Russian (initially, the Soviet Union) performance using a comparable PPP measure for a longer period. In 1978, the first year of Chinese reform, per capita GDP in China accounted for only 13 per cent of that in the Soviet Union. After 25 years of reform, it achieved 76 per cent of that in Russia in 2003. During this period, GDP per capita in China increased to 4.91 times its 1978 level, whereas GDP per capita in Russia shrank

Table 7.1 Economic performance in China and Russia during the reform period

	China	Russia (and USSR)	China/Russia (%)
GDP (US\$ billion 1990 PPP)			
1978	935	1,018	92
2003	6,188	914	677
Growth (2003/1978)	662%	90%	
Per capita GDP (US\$ 1990 PPP)			
1978	978	7,420	13
2003	4,803	6,323	76
Growth (2003/1978)	491%	85%	

Source: Maddison, A., 2007. *Chinese Economic Performance in the Long Run*, second edition, Organisation for Economic Cooperation and Development, Paris: Tables 4.4–4.5, p.102.

to 85 per cent of its 1978 level. In the same period and by the same measure, total Chinese GDP expanded from 92 per cent to 677 per cent of that in Russia (Table 7.1).

Russia experienced rapid economic growth in the post-Yeltsin period, although this was still a recovery towards its initial levels before the economic shock. In 2006, Russian GDP in constant prices was equal to only 97 per cent of its 1990 level, whereas the same ratio was 470 per cent for China (UN various years).

The next part of this chapter discusses the reasons for the different economic performances, and what lessons can be drawn from past reforms.

Chinese and Russian reforms: what made the difference?

Economists have offered various explanations for why the outcomes of the Chinese and Russian reforms were so different. It is commonly accepted that the speed and sequence of reforms are important. Unlike Russia's shock therapy, China made a step-by-step movement towards a market economy. This evolutionary approach not only smoothes the shock, it allows macroeconomic stabilisation and institutional building to be achieved. While the old central-control mechanism is gradually replaced by market mechanisms, rapid economic growth is achieved (for example, McKinnon 1993; Roland 2000; Maddison 2007).

Justin Lin (1995) provides a convincing, although incomplete, explanation for the Chinese–Russian contrast. He indicates that China and Russia had heavy resource misallocation under the centrally planned system, but reallocation of resources among sectors takes time. A sudden correction of price signals leads to production decreases in the sectors with over allocation of resources, but not to corresponding increases in the sectors in which resources are under allocated. According to Lin's explanation, the Chinese approach was to allow market-oriented growth in the under-allocated sectors first, so that misallocation was corrected in a relatively long period without drops in production (Lin 1995). Nevertheless, he did not explain why the real growth path in Russia in the reform period showed as an L-curve instead of a J-curve—that is, how can an expected temporary production decrease become a 10-year-long economic disaster?

Some other authors emphasise the different initial conditions in China and Russia. They argue that given these differences, the Chinese experience is not replicable, and the Russian recession is unavoidable. Among them, Popov (2000, forthcoming) shows, via a cross-country analysis, that the worse the economy distorted previously, or the higher the initial per capita GDP, the larger is the drop of output seen in liberalisation of a transitional economy.

Popov also indicates that the speed of liberalisation has a negative impact on output, although he does not treat the speed of liberalisation as a policy variable, but as an 'endogenously determined' variable, which is determined by the political situation. In this sense, all the policy changes already in place could be classified as being endogenously determined, although some are really imported. In addition, it is hard to believe that the Chinese economy was previously less distorted than other transitional economies.

One dimension of the Chinese and Russian reforms was never sufficiently discussed—that is, did the reforms lead to a process of 'Pareto improvement'? If not, who won and who lost? How were public interests affected in the reform? And how was economic performance related to the issue of interest redistribution during the reform and post-reform periods?

In the remaining parts of this chapter, I will show three points via a comparison of some reforms in China and Russia: first, most of the reforms in China have led to improved conditions for all groups of people; therefore, the Chinese reform has generally been a process of Pareto improvement. This was not the case in Russia because the reforms led to improvements for certain interest groups, but the majority of people were worse off in the long term. Second, most of the reforms in China were indigenously and endogenously determined, often after many policy debates and empirical experiments; therefore, they were usually in the interest of all the people or at least the majority of the people.

This explains why the reforms could be in a path of Pareto improvement. In Russia, some major reform measures were determined externally and by a small group of élites, although they were undertaken in the name of public interest. Third, the reform outcomes in China and Russia indicate a strong link between economic performance and interest redistribution—that is, a reform benefiting all groups of people is usually a process of Pareto improvement, leading to better economic performance. This implies that whether the reform policy takes the public interest as its priority is crucial for the economy.

The following sections of the chapter comprise reviews of three major reforms in China compared with those in Russia.

Agricultural reform

Agricultural reform in China, beginning in 1978, was the first step in the country's economic reforms. As a replacement for the old and inefficient commune system, the rural HRS was not a government-designed reform measure. It was an innovation by farmers originating from the mid 1950s, and brought consistently better outcomes for increasing output and reducing rural poverty in pilot practices from the 1950s to the 1970s. It also incurred many political attacks, and was several times suppressed by top leaders for ideological reasons (RGCRD 1981).

During 1978–80, farmers in different regions reintroduced this system and achieved remarkable success in increasing agricultural output and incomes; the system therefore spread automatically to broader areas. In Anhui and Sichuan Provinces, it was supported by provincial leaders Wan Li and Zhao Ziyang,¹ but was attacked by conservative leaders at the central and local government level as a serious crime of 'anti-socialism'. The following is an example of a typical debate from 1980 between Wan Li and an anonymous senior official, 'A', both of whom were responsible for the central government's agricultural policy at the time (Zhao 2007):

A: HRS does not fit the socialist character, therefore, it should not be widely applied.

Wan: Why not? This is what people want; they only want to get enough food.

A: It deviates from the socialist direction; it is not a road towards 'common prosperity'.

Wan: Socialism and the people, which one would you choose?

A: I choose socialism!

Wan: I choose the people!

The real outcome of the HRS was, however, more convincing than any ideology. After many conflicts, the HRS was accepted and promoted formally by the central government in 1982. Until 1984, more than 97 per cent of Chinese villages adopted the HRS. The commune system was abolished.

The HRS is a household-based farming system that does not alter collective land ownership, but distributes farm land to households under long-term contracts. Unlike the old commune system, it provides adequate incentives and autonomy to farmers. In 2006, all land contract levies, together with agricultural taxes, were abolished; land use is now free for farmers.

With the introduction of the HRS, the pricing mechanism of agricultural products was also changed. The government first increased the State's purchasing prices for grain by 20–50 per cent in 1979, and then gradually liberalised the grain market. Similar things happened to other agricultural products. The HRS reform, plus price increases, led to remarkable increases in agricultural output and farmers' incomes in the early 1980s. The longstanding problem of food shortages was resolved. In real terms, farmers' per capita incomes in 1984 increased by 2.5 times its 1978 level. The proportion of the rural population living in absolute poverty was reduced by half—from 250 million to 128 million (Table 7.2). Urban–rural income disparity was also reduced.

Another important condition for the success of the agricultural reform was that, in the initial stage, reformers entered and dominated the core group of the Chinese leadership. They had rich working experiences and good knowledge of agricultural issues, they understood the needs of rural people and made rural development and the improvement of people's lives a target for reform.

Table 7.2 Farm output and income before and after agricultural reform in China

	1978 (before HRS)	1984 (after HRS)	1984/1978 (%)
Grain (Mt*)	304.8	407.3	134
Cotton (Mt)	2.2	6.3	289
Oil-bearing crops (Mt)	5.2	11.9	229
Fruit (Mt)	23.8	47.8	201
Rural income per capita (yuan)	134	355	250 ^a
Rural poverty (million people)	250	128	51

* Mt = mega-tonnes

^a income levels in current prices, but the relative change is calculated in constant prices

Source: National Bureau of Statistics (NBS), 2005. *China Compendium of Statistics 1949–2004*, China Statistics Press, Beijing.

Agricultural reform in Russia was very different. In the early 1990s, the leadership accepted the advice of the International Monetary Fund (IMF) and set a target for agricultural reform to follow the US agricultural model, and scheduled to develop one million private farms. To achieve this, they privatised agricultural land, disbanded state farms and collective granges and withdrew all state subsidies for agricultural production. This type of reform did not have the support of the majority of rural people. According to a survey (Qiao 2002), only 32.2 per cent of Russian farmers supported land privatisation without reservation, while 39.7 per cent opposed it. Only 18.1 per cent of farmers supported the free trade of land, while 60 per cent opposed it.

Prices for agricultural products were liberalised completely, together with all other products in 1992, and this immediately caused hyperinflation. Input prices for farming increased much faster than output prices, resulting in rapid decreases in farmers' incomes. From 1990 to 1998, grain production dropped by 46 per cent, and the gross value of agricultural output dropped by 47 per cent. In 1999, 53 per cent of Russian rural residents lived below the official poverty line. Agriculture in Russia has improved in recent years, although it is still recovering from recession.

In general, the agricultural reforms in China were a 'bottom-up' process. It adopted a model preferred by most farmers, which led to quality-of-life improvements for nearly all the 790 million rural residents—who accounted for 82 per cent of the total population in 1978. The urban population also benefited because the food-supply situation was much improved. The reforms also made significant contributions to overall economic performance. In contrast, agricultural reforms in Russia followed a 'top-down' approach: the leadership imposed an imported agricultural model on farmers without considering indigenous needs and local situations. The outcome of the reform was undesirable, and most people suffered because of it.

Price reform

Price reform in China was a crucial part of its transition to a market economy. A 'dual-price system' was formed gradually in the early and mid 1980s. As a transitional measure towards a market economy, this system allows market prices to work while planning prices remain; this smoothes economic shocks and maintains economic growth in the early stages of reform.

During 1978–80, a large number of state-owned enterprises (SOEs) were brought into the experimental schedule of 'expanding enterprise autonomy'. They were allowed to sell any excess above their state quota of products outside the state plan, at flexible prices, and were also allowed to purchase inputs

outside the plan at flexible prices, when the state supply was not available. This experiment was started in Sichuan Province in 1978 and achieved good outcomes, so it soon expanded to cover 6,600 SOEs across China in 1980, and then applied to all SOEs. This formed a market system that coexisted with the planned system. The market prices indicated the direction of demand, gave enterprises incentives and played a role in supply–demand adjustment at the margin.

After the initial success, debates about price reform were still going on in the mid 1980s, focusing on a few questions: 1) should planning prices or market prices play the dominant role in the economy; 2) how could the imbalanced economy be brought into equilibrium—that is, first via administrative adjustment of controlled prices or by liberalising price controls; 3) should these adjustments or liberalisation be done as fast as possible or over a relatively long period (for example, Chinese Institute for Economic System Reform 1987)?

It became clear that controlled prices were not functioning well, and further market-oriented price reforms were needed. Price reforms that were too radical, however, would exceed the economy's capability to bear the shock. As a result, the government persisted with a dual-price system in the 1980s. The scope of state planning and price control was gradually reduced or liberalised in some industries, where there was equilibrium or excess supply, but was kept essentially at the same level in other fields where there was a serious shortage of supply, such as in the steel industry.²

This was because, in these fields, the gaps between the controlled and market-determined prices were large (for example, by then, the market price for steel was three times higher than the controlled price); a sudden abolition of controlled prices would have led to violent changes in input prices and serious shocks to firms in downstream industries, and to consumers. Serious inflation, unemployment, enterprise bankruptcy and economic declines would be expected.

Nevertheless, for basic inputs, even though price controls remained, prices for products were increasingly market oriented. The higher market prices provided incentives to firms to meet additional demand. In the 1980s, the output of steel increased from 37 to 66 mega-tonnes (Mt) (NBS 2005), most of which was produced by SOEs, but was promoted by market prices. Along with economic growth, the relative importance of market prices increased and that of controlled prices shrank.

In 1988, top leaders attempted to launch a 'price-reform storm' to liberalise the remaining portion of controlled prices. This scheme resulted in massive panic purchasing of consumer goods and bank squeezes, so the leadership soon decided to abandon it.

Another important contributing factor to price reform was the rapid growth of market-oriented non-state enterprises. This substantially increased the scope for market prices to work. The non-state enterprises gradually became dominant in the economy, and finally led market prices to play the dominant role. Table 7.3 shows how the price mechanism transformed.

While prices were gradually marketised, price levels during the transitional period were basically stable, and hyperinflation was avoided. The consumer price index (CPI) as an annual average for the three decades from 1978–2007 was 5.5 per cent. During this period, the CPI exceeded 10 per cent in only five years: 1988–89 and 1993–95. The CPI reached its highest level—24.1 per cent—in 1994. The annual CPI remained below 3 per cent in 16 of the 30 years.

A decade after the beginning of price reforms, China had essentially grown out of the ‘shortage economy’ of the early 1990s. Serious supply bottlenecks were eliminated. The economic structure became more balanced. Most importantly, most commodity prices were determined via market competition, which substantially promoted efficiency increases.

In Russia, all prices were suddenly liberalised in January 1992 by the Yeltsin administration without sufficient discussion or preparation. The main ‘theoretical’ base was an analogy: ‘You cannot leap over a ditch in two jumps.’ Radical price reforms led immediately to hyperinflation. Using 1991 as the base year (100 per cent), the CPI reached 1,629 per cent in 1992, 15,869 per cent in 1993 and 64,688 per cent in 1994. The majority of people’s savings disappeared. The serious inflation forced the enterprise sector to increase nominal wages for workers to survive, the enterprise sector then forced the central bank to issue money to finance the unavoidable increases in nominal wages, and the rapid increases in monetary supply further fuelled hyperinflation. In 2000, the CPI

Table 7.3 **Proportion of products subject to market prices, 1978–2005**
(per cent)

	1978	1997	2005
Controlled price	>90	11.9	7.2
Guided price		3.6	
Market price	<10	84.4	92.8

Note: Calculated as weighted average of retail commodities, production inputs and agricultural products in gross value.

Source: Fan, G., Wang, X. and Zhu, H., various years. *NERI Index of Marketization of China’s Provinces*, Economic Sciences Press, Beijing.

reached 9,344 times the 1991 level (UN various years). The Russian experience of price reform presented a real challenge to the 'Washington consensus', because its radical price liberalisation did not allow macroeconomic stability to be achieved—although both were necessary, according to the Washington consensus.

Even though nominal wages increased dramatically, price increases were twice as high as wage increases. Most people suffered from income drops and the unemployment rate increased substantially during this period. Production collapsed, and GDP decreased year by year. Until 1998, GDP dropped to only 57 per cent of its 1990 level in real terms. Sixteen years later, in 2006, GDP in Russia had not fully recovered to its 1990 level.

Price reform is not itself an objective in former centrally planned economies; rather, the objectives are better incentives, improved efficiencies and optimised resource allocation. As indicated by their economic performance, these were achieved in China, but not in Russia. Table 7.4 compares inflation, unemployment and economic growth data for China and Russia during the first decade of their price reforms (1980–90 for China and 1990–2000 for Russia).

To summarise the price reforms in China, the dominant position of market prices in the economy was finally established via a gradual process of evolution. This reform strategy was based mainly on the consideration of macroeconomic stability as well as protecting consumers, workers, enterprises and the State from the shocks of inflation, unemployment, production shrinkage and reductions in budgetary revenue. These goals were achieved. In Russia, all the negative impacts were considered to be a necessary cost to pay for the ultimate objective of liberalisation. Radical price liberalisation resulted in serious disadvantages for the majority of people, as well as heavy economic losses.

Ownership structure transformation

State-owned enterprises dominated the Chinese non-agricultural industries before the reforms. They shared 78 per cent of the gross output value of industry in 1978; the remaining 22 per cent was shared by collective enterprises. Transformation of the ownership structure of the economy began with development of Township and Village Enterprises (TVE) in rural areas, and foreign-funded enterprises (FEs) and enterprises with investment from Hong Kong, Macao and Taiwan (HMTes) in four special economic zones in the 1980s. After these enterprises achieved good results, the development of FEs, HMTes, private enterprises and joint-stock companies was officially promoted.

Table 7.4 Price reform in the first decade: inflation, unemployment and GDP growth (per cent)

	China, 1980–90	Russia, 1990–2000
CPI (annual average)	7.0	276.2 ^a
GDP growth (annual average)	9.3	–4.2
Unemployment rate	4.9, 2.5 ^b	5.4, 13.4 ^c

^a 1991–2000

^b urban unemployment rate for 1980 and 1990, respectively

^c total unemployment rate for 1990 and 1998, respectively

Sources: United Nations (UN), various years. *Monthly Bulletin of Statistics*, online database, United Nations; National Bureau of Statistics (NBS), 2005. *China Compendium of Statistics 1949–2004*, China Statistics Press, Beijing; National Bureau of Statistics (NBS), 2007. *China Statistical Yearbook 2007*, China Statistics Press, Beijing. World Bank, 2007. *2007 World Development Indicators*, World Bank, Washington, DC.

There was a lot of debate about non-state enterprises in the 1980s. An influential opinion in the government was that these enterprises competed with SOEs for inputs and markets, ‘undermining the socialist economy’, and they should therefore be banned or restricted; others argued that these enterprises provided new employment opportunities, lifted people’s incomes, produced various consumer goods that were needed in the market and contributed to the State’s revenue, and should therefore be developed further. The latter view dominated central government policy after the mid 1980s, and became more and more convincing when non-state sector development performed better than the state sector.

During 1980–90, TVE employment increased from 30 million to 93 million, and the share of TVEs in the value of gross industrial output (GIOV) increased from about 5 per cent to 20 per cent. Private enterprises, HMTes, FEs and joint-stock companies also grew rapidly; they shared only 0.75 per cent in GIOV in 1980, but this increased to 9.8 per cent in 1990. They became the main engine of economic growth in the 1990s and shared 68 per cent of GIOV in 2007. In 2007, the entire non-state enterprise sector shared 70.5 per cent of industrial output. Urban non-state enterprises employed 229 million people in 2006—representing 77.3 per cent of urban employment. The formerly state-dominated economy has basically transformed into a private sector-dominated economy. Table 7.5 shows the changes in the industrial sector in the past three decades.

Table 7.5 Ownership structure of the industrial sector (share in gross output value) (per cent)

Year	SOE	Non-state enterprises		
			Collective	Private ^a
1978	77.6	22.4	22.4	.
1990	54.6	45.4	35.6	9.8
2000	47.3 ^b	52.7 ^c	13.9	38.8
2007	29.5 ^b	70.5 ^c	2.7	67.8

. insignificant

^a private sector, including private enterprises, foreign-funded enterprises and joint-stock companies

^b SOE data for 2000 and 2007, including joint-stock companies with a controlling state share

^c data exclude small non-state enterprises with annual sales below RMB5 million

Sources: National Bureau of Statistics (NBS), 2005. *China Compendium of Statistics 1949–2004*, China Statistics Press, Beijing; National Bureau of Statistics (NBS), 2007. *China Statistical Yearbook 2007*, China Statistics Press, Beijing. National Bureau of Statistics (NBS), 2008. *2007–2008 Collection of Statistics*, China Economic Monitoring and Analysis Center of the National Bureau of Statistics, CEMAC Print, Beijing.

The transposition of the state and non-state enterprises in the economy was due basically to two elements: continued robust growth of the private and foreign enterprises during the past three decades, which was much faster than the growth of the SOEs, and privatisation of SOEs, mainly from the late 1990s onwards.

Whether the SOEs should be privatised was a controversial issue. Although SOEs became market oriented to a certain extent, their performance was generally undesirable. From 1984 to 1996, the net value of fixed assets in SOEs in the industrial sector increased from CNY340 billion to CNY2,386 billion, whereas their total profits decreased from CNY71 billion to CNY41 billion (all in current prices). Their profit/assets ratio was only 0.8 per cent, and the profit margin (profit to total sales) was only 1.5 per cent in 1996—both significantly lower than the average (1.7 per cent and 2.6 per cent, respectively). During the same period, the SOEs' total losses increased from CNY2.7 billion to CNY79 billion (in current prices), which led to a big deduction in their profits (NBS 1997, 1998). At the same time, non-performing bank loans built up to the trillion-yuan level, mainly due to SOEs. The 1997 East Asian financial crisis further sharpened the pain.

In 1997, the central government formally adopted a new policy called 'seize the big and free the small' (State Council 1997), allowing small SOEs to be sold. The policy for large and medium-sized SOEs emphasised improving their

management and transforming them into ‘modern enterprise systems’—that is, joint-stock corporations and limited-liability companies.

The number of SOEs in the industrial sector reduced from 113,800 in 1996 to 24,961 in 2006 (the latter figure included pure SOEs and joint-stock corporations with a controlling state share; hereafter, called state-controlled enterprises, or SCEs). Their employment in industry reduced from 43 to 18 million people. Most small SOEs were fully privatised.

The remaining SCEs in the industrial sector produced less than 30 per cent of the total industrial output in 2007. Their performance, however, was much improved. Their total profit increased from CNY41 billion to CNY849 billion during the period 1996–2006, and the profit/asset ratio increased from 0.8 per cent to 6.3 per cent, which was close to the industrial average of 6.7 per cent.³ Non-performing loans reduced substantially; they accounted for 23.6 per cent of total loans in 2002, and reduced to 6.7 per cent in 2007. This implies that previous policies for improving SOE management and non-state share participation have been effective.

While a large number of SOEs have been privatised, the general performance of the private sector has improved significantly, implying better achievement of the privatised former SOEs.

Privatisation of the SOEs was not, however, a painless operation. Twenty million SOE workers were laid off in 1998, with another 26 million in later years until 2006. The lack of a social-security system in the first few years meant that laid-off workers received only limited financial support and some of them immediately experienced hardship. This was a real shock to a large part of the population, although it was less serious than what happened in Russia. The development of the non-state sector meant it was able to provide many job opportunities for the re-employment of laid-off workers, especially in the coastal areas where the non-state sector was better developed.

Another negative outcome was low transparency and unfair distribution of the former state assets in some regions, where the process of privatisation was not well regulated or monitored and many under-the-table deals benefited mainly a small group of people.

To rethink the process of SOE reform, the negative effects might have been reduced if the social-security systems had been built earlier and the process of reform had been better regulated, more transparent and introduced step by step.

Although there were some similarities between China and Russia in SOE privatisation, it was a more painful process in Russia than in China. Russia's SOE privatisation began in 1992, when a large proportion of state assets was

distributed to all Russian residents in the form of warrant stocks worth 10,000 rubles per person. The privatisation program was designed by a small group of élites, who regarded privatisation itself as being the supreme objective, even above the public interest, although such a design seemed fair because everyone had equal shares. Because of hyperinflation caused by the radical price reform, the value of the warrant stocks soon shrank to the price of a pair of shoes. This provided an opportunity for those who were astute enough to collect the warrants from the public at extremely low prices. The enterprise shares soon became highly concentrated and a small number of people became rich owners of the former SOEs (for example, Freeland 2000).

The remaining state assets were sold later, usually at token prices to insiders and those who had relationships with government officials. The second phase of privatisation was even less fair, due to manoeuvring behind the scenes and so on. In a number of industries, privatisation did not bring about market competition; instead, the state monopoly was replaced by private monopolies or oligopolies. In particular, those state companies holding the most valuable natural resources, such as oil and natural gas, were privatised in a non-transparent and very unfair way. This allowed a small group of oligarchs to pay nothing to become the owners of half of Russia's national wealth. This was why the Putin administration had to carry out a re-nationalisation program of oil companies.

In the Forbes world-100 rich list for 2007, Russia had 13 of the world's richest people, most of whom were oil oligarchs, and China had none.

As well as being unfair, radical privatisation in Russia, together with radical price reform, caused heavy economic losses instead of real economic growth. As indicated earlier in this chapter, GDP in Russia in 1998 dropped to only 57 per cent of its 1990 level. The only comparable scale of economic disaster in modern Russian history was during World War II. Up to 2006, GDP in Russia had recovered to 97 per cent of its 1990 level, but this recovery should be attributed partly to increasing world oil prices, as Russia is an important oil exporter.

The experiences and lessons of privatisation in China and Russia are meaningful. They show that, when the public interest is taken as the first priority of reform objectives, the outcome is more likely a Pareto improvement and this fertilises economic growth and development. This is represented by the results of non-state sector development in China. On the contrary, when a certain ideological objective—whether a communist or a capitalist one—or the interests of a certain group of people are placed above the public interest, an inefficient redistribution of resources or wealth is likely to occur. This was the case in Russian privatisation, and to some extent in China's SOE privatisation program in the late 1990s.

Implications for further reform

The theory of public choice shows that even a publicly elected government in a democratic country can make decisions contrary to the public interest, and an election can itself lead to a result not in accordance with the majority's interests (Buchanan and Tullock 1962; Arrow 1963). This explains what happened in Russia in the reform period. The theory also leads to the issue of 'government failure' against 'market failure', and therefore to a solution of 'small government'. The reform experiences in China and Russia indicate, however, that the size of government should not be the only concern—or even the major concern. A more important issue is how to impel the government to behave in the public interest with a long-term perspective, and to play a role as an impartial arbitrator in social conflicts between interest groups.

Although reform in the past three decades has achieved great success in China, the above issue remains unresolved in an institutional base. After the establishment of a basic market framework, a lot of new problems appeared—relating mainly to the role of the government.

Income inequality is widening. According to the World Bank (2006), the Gini coefficient increased from 0.32 to 0.45 during the period 1980–2001. It is likely to be even greater because unreported income (including illegal income) is huge, and is concentrated to a small proportion of high-income earners (Wang 2007). Rent-seeking behaviour and corruption in the public sector are increasing; there is evidence of unjustified distribution of returns from land, natural resources and financial resources.

It is natural that income inequality increases to a certain extent when the economy is in a market-oriented transition. The continued income divergence indicates that other factors are also at work—due mainly to institutional defects or incompleteness, which leads to distortions in income distribution, challenges for social justice, and creates uncertainty for social stability and growth sustainability in the long run. This is because the old central-planning framework is withering away, but a new institutional framework has not been completed. This indicates a need for further reform: mainly institutional innovations towards a more transparent, better monitored government system, including better regulated public resource management and better managed public services, and also an effective legal framework and better law enforcement. These are the necessary conditions for sustainable long-run growth and development towards the middle of the twenty-first century.

Notes

- 1 At the time, Wan and Zhao were the provincial party secretaries of Anhui and Sichuan, respectively. Wan became a vice-prime minister and the director of the State Agriculture Committee in 1980, and the chairman of National People's Congress Standing Committee between 1988 and 1993. Zhao became the prime minister (1980–87) and then the general secretary of the Communist Party (1987–89).
- 2 Much of the information on the process of reform in China was based on the author's personal experience while working for the State Committee for Economic Restructuring of China. This is the case below unless otherwise referenced.
- 3 This improvement should be discounted to some extent because 43 per cent of the SCE profit came from oil companies, which benefited mainly from increasing oil prices. Nevertheless, after deduction of this, the improvement is still significant.

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