Beijing Discretion
A Critique of the Washington Consensus

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Introduction

China’s successful reforms since 1978 have attracted much attention the world over. Not only has the country’s economic growth been phenomenal, but this stellar performance stands in stark contrast both to the dismal outcome of reform efforts in Eastern Europe and the alarming decline of Latin America, the growth miracle of yesteryear. So what exactly sets China apart from other countries that have either failed to grow or have stagnated dramatically?

This paper attempts to answer this question. However, it does not suggest a prescription for growth and development that might henceforth be called the “Beijing Consensus.” On the contrary, this paper shall expose the weaknesses of prescriptive growth strategies that have sidetracked the development discourse onto a path of irrelevance.

John Williamson’s (1990) neologism, “Washington Consensus”—a list of ten reforms that were deemed as necessary and sufficient conditions for achieving and sustaining economic growth—was touted as an answer to the development question. The foundations of this edifice were shaken by the crisis in Latin America, a region that had been praised for following the Washington consensus reforms satisfactorily. The post-Washington consensus emerged, suggesting that the original consensus had failed to consider market failures and the need for institutions responsible for introducing reform. Subsequently, revisions were made to the consensus, but its core principle—that government intervention be minimal—still held sway. Faith in the neoliberal agenda was rekindled by the Asian financial crisis, which was attributed to excessive government intervention under the developmental state model. The revisions thus suggested that the original consensus was not misguided, but somewhat deficient and not applied to an adequate extent. Therefore, the focus shifted from macroeconomic stability to the establishment of institutions that would enforce the old consensus.

Although none of the suggestions of the old or the new consensus are incorrect, their focus is narrow in scope and idealistic; the prescriptions rest on the assumption that the institutions existing in the

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developed world are the best way to organize an economy. That might be true. However, ours is not a perfect world; to make the most of the existing set of conditions in developing countries, one must utilize not best-practice institutions but those that are compatible with the social, political, and economic conditions existing in the country. The Washington agenda has rendered development policy irrelevant because it implies that economic and political liberalization are the ends of development policy rather than the means. One must jettison ideological biases and remember that the goal of development policy is to initiate and sustain growth and development regardless of the type of institutions used for doing so. This is precisely what China has done.

The reforms introduced in 1978 flouted most of the rules that form the very core of the Washington consensus, and orthodox economics in general, but still achieved sparkling success. The inference that one ought to draw from the Chinese experience is not that the consensus is wrong and should be ignored, but that it is more of an analysis of what developed countries have done right than what developing countries ought to do. Neither is China to be emulated by every developing country. It has achieved success purely because it made the most of the conditions existing at the time the reforms were introduced. Every country should thus learn one lesson from Beijing: development policy is not a trans-contextual monolith; instead it is a dynamic process that must take regional and temporal conditions and variations into account. China made the most of the linkages among existing institutions and was quick to adapt to changing circumstances; herein lies the key to its success.

The first part of this paper will describe the Washington consensus and the revisions made to it following the emergence of the post-Washington consensus. The second section will critique the logic behind all prescriptive approaches to development. The third part will discuss the success of Chinese reforms with a focus on how the success relied on the innovative nature of the country’s transitional institutions. It will also show how after laying the foundations of a move towards a market-based economy, China has made some progress towards a conventional market economy. The final part will analyze China’s growth and observe the extent to which the model should be emulated by other transition economies.
• **Part I: The Washington Consensus: Old, Post, and New**

Williamson (1990) was a response to the Latin American debt crisis. While the region had exhibited impressive growth until the beginning of the 1980s, by the end of "the lost decade" it was evident that what had begun as an economic slump following the oil crisis was symptomatic of greater imbalances in the region's economies. To correct those imbalances, Williamson suggested the ten-pronged agenda that he called the Washington consensus:^2

1) **Fiscal discipline**: since large and sustained fiscal deficits contribute to inflation and capital flight, the government should keep them to a minimum.

2) **Public expenditure priorities**: subsidies should be reduced or eliminated, and government spending should be directed towards education, health, and infrastructure development.

3) **Tax reform**: tax revenue should be increased by broadening the tax base through moderate marginal tax rates.

4) **Interest rates**: interest rates should be used as a tool for discouraging capital flight and encouraging saving. Domestic financial markets should be allowed to determine interest rates with minimal government intervention.

5) **Exchange rates**: exchange rates must be competitive so that exports do not suffer.

6) **Trade liberalization**: barriers to trade should be minimized, especially in the case of intermediate goods required for producing exports.

7) **Foreign direct investment**: all possible measures should be taken to encourage investment from abroad because it not only brings much needed capital, but also technical know how.

8) **Privatization**: state-owned enterprises ought to be privatized in order to increase efficiency in the economy.

9) **Deregulation**: excessive regulation fosters corruption and discourages investment. Private enterprise should be encouraged by removing bureaucratic hurdles as much as possible.

10) **Property rights**: strongly enforced property rights are essential to encourage saving and investment.

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There is nothing wrong with this agenda; indeed these are necessary conditions for a well-functioning economy. However, they are by no means sufficient conditions; the agenda assumes a mature capitalist economy. Certainly, if the assumption were always true, the consensus would have been the elixir that Latin America needed.

Of course, that was not the case and the reforms failed to revive the region’s economies.\(^3\) Hausman and Rodrik (2002) say that according to Morley et al.’s (1999) index of structural reform, governance improved in Latin America, but growth slowed.\(^4\) It thus became clear that the problem was more deep-rooted than the consensus assumed. Despite its obviously narrow scope that ignored the context in which reforms were introduced, the Washington consensus was popular because the appeal of American-style capitalism was at its zenith in 1989 after the collapse of the Soviet Union. Since central planning had proven to be a failure, the neoliberal agenda took the debate to the other end of the spectrum by asserting that the state had absolutely no role to play in the economy. Not only did developing countries have to reorient their economic policy in line with the consensus prescriptions to be considered Western allies in the complete sense, but IMF and World Bank assistance was also contingent on the introduction of reforms based on the consensus.\(^5\)

Stiglitz (1998a) criticized the Washington consensus and called for a post-Washington consensus:

“In leaving out history, institutions, and distributional considerations, neoclassical economics was leaving out the heart of development economics. Modern economic theory argues that the fundamentals (resources, technology, and preferences) are not the only...determinants of economic outcomes...even without government failures, market failures are pervasive, especially in less developed countries.”\(^6\)

Government intervention to rectify market failure was thus called for.

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\(^3\) After growing at an average annual rate of about 5 percent in the 1960s and 1970s, Latin American economies grew by 2 percent (0 percent per capita) in the 1980s. The trend barely changed in the 1990s: growth was a modest 3 percent for the decade (barely 1.5 percent per capita) (Birdsall and de la Torre (2001), p. 19).


\(^5\) Naim (2000), p. 90

\(^6\) Fine (2001), p. 18
In the wake of this criticism, Williamson’s 7 (2003) position underwent some changes. He acknowledged that the original consensus assumed the existence of institutions that were needed to implement the reforms. Williamson thus rejected criticism that the agenda was misguided, responding that it had an indispensable contribution to make if the stabilization reforms were followed by “second generation reforms” that focused on institution-building. 8 He also emphasized the importance of the welfare aspect of the debate that lay at the heart of the distinction between economic growth and development; that is, policy should attempt to reduce either absolute or relative poverty. Hence Williamson approved of the “Washington Contentious” reforms introduced by Birdsall and de la Torre (2001) that would improve equity without harming growth. 9

The change in Williamson’s position meant that he shed the aggressive pursuit of short term goals to adopt a more gradual and forward-looking reform process. Therefore, he broke up his agenda into four different phases. The first phase, “Crisis Proofing,” is much like the original consensus; it focuses on macroeconomic indicators and variables, such as budget deficits, exchange rates, inflation, and so on. The second phase, “Completing First-Generation Reforms,” emphasizes the importance of efficiency in some core sectors of the economy—labor markets, financial markets, state-owned enterprises that ought to be privatized, and exports markets. Then “Second-Generation Reforms” turn to the importance of institutions that were first emphasized by Naim (1994): “The agenda of ‘second-stage reforms’ is devoted to building the institutions—a modern, efficient, noncorrupt civil service and judiciary being perhaps the most central of them—that will permit those core functions to be fulfilled efficiently.” 10 Since Williamson (2003) himself accepts the shortcomings of the consensus—“The legitimate criticism of the reforms is not that they have contributed to poverty, but that they have so far failed to address the structural causes of...

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8 Ibid, p. 10
9 The “10+1” agenda they propose includes: (1) rule-based fiscal discipline; (2) smoothing booms and busts; (3) social safety nets that trigger automatically; (4) schools for the poor, too; (5) taxing the rich and spending more on the rest; (6) giving small business a chance; (7) protecting workers’ rights; (8) dealing openly with discrimination; (9) repairing land markets; (10) consumer driven public services; (plus 1) reducing rich country protectionism (Birdsall and de la Torre 2001), p. 11-14.
10 Williamson (2003), p. 329
poverty"\textsuperscript{11}, the development aspect is accounted for in the final phase, "Income Distribution and the Social Sector."

Responding to the post-Washington consensus, Williamson has thus recognized the importance of government intervention and institutional complementarities. Williamson (2004) insists that, with these revisions, the Washington consensus serves its purpose: "Indeed, the basic purpose of thinking about development strategy is to identify regularities about policies and institutional arrangements that suggest what might be useful in other countries."\textsuperscript{12} In this manner, the basic assumption of the universal existence of markets remains intact. The only difference between the old and the new consensus is that the latter admits that markets require government intervention and non-market institutions. This assumption informs the distorted view that development policy ought to follow a universal set of policies with economic and political liberalization as the ultimate goal.

\textsuperscript{11} Williamson (2003), p. 309
• **Part II: The Consensus Family under Attack**

The revised Washington consensus differs from the old consensus in two main ways. First is the advocacy of a milder or slower opening of the economy to the dictates of the market, drawing upon the analysis of market failure. Thus room is left for the state to address market imperfections. Second, there is emphasis on institutional complementarities, economic and non-economic factors that foster social cohesion. This reorientation represents progress because it recognizes that development is a process of profound social transformation. There is thus recognition of the importance of social and historical context for economic development.\(^{13}\) Although this recognition of state intervention and institutional complementarities marks progress, the intricate relationship among the state and other institutions renders the consensus-based approach to economic reform impractical.\(^{14}\)

The new consensus replaces the notion of state *versus* market with state *and* market to overcome market imperfections. This revision disregards the fact that the relationship between state and market, as well as their respective roles and interactions, is the consequence of underlying economic and political relations that condition and is, in turn, conditioned by socio-economic structures.\(^{15}\) This is where the Washington consensus and all derivations of it ignore the ground reality; in some developing countries markets, as we understand them, do not exist. Although the optimal economic arrangement would

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\(^{14}\) To understand the idea of institutional complementarities, the following passage from Rodrik (2002a) is more illustrative than any definition: “Imagine a Western economist had been invited in 1978 to give advice on reform strategy to the Chinese leadership. How would she formulate her advice, in light of what we ‘know’ today? Being a sensible economist, she would presumably know that the place to start would be agriculture, as the vast majority of the Chinese population lives in the countryside. Liberalization of crop prices would be the number one item on the agenda. Cognizant that price incentives make little difference when farm incomes accrue to communes, she would immediately add that privatization of land must accompany price liberalization. Reminded that the obligatory delivery of crops to the state at controlled prices is an important implicit source of taxation, she would then add that tax reform is also required to make for the loss in fiscal revenues. But another problem then arises: if the state cannot deliver food crops to urban areas at below-market prices, will urban workers not demand higher wages? Yes, that requires some reforms too. State enterprises need to be corporatized so they can set their wages and make their hiring and firing decisions freely. (Privatization would be even better of course.) But if state enterprises now have autonomy, will they not act as monopolies? Well, anti-trust regulation, or trade liberalization as a short cut, can take care of that problem. Who will provide finance to state enterprises as they try to restructure? Clearly, financial market reform is needed as well. What about workers who get laid off from the state enterprises? Yes, that’s why safety nets are an important part of any structural adjustment program. And so on...” (Rodrik 2002a, p. 7).

\(^{15}\) Fine (2001), p. 14
certainly include the existence of markets that function themselves, as the original consensus assumes, or at most required government intervention to address market failure, as the revised consensus assumes, sometimes this is simply not feasible. It thus becomes imperative to study how informational imperfections that arise within, and are transmitted through, the market might be corrected by non-market institutions.\footnote{Fine (2001): p. 15}

Alice Amsden (1991) observes the role played by the developmental states of East Asia and how they used an effective combination of carrot and stick policies to ensure that domestic industry matured enough to compete on the world markets eventually. She argues that the absence of effective government supervision during Latin America’s import substitution industrialization phase meant that the region was not competitive enough when protectionist barriers were removed. This comparison illustrates the point that government intervention is not a good or a bad thing ex ante. Without effective government intervention, a region might be fulfilling stabilization criteria, such as the Washington consensus agenda, without developing the capacity for sustained growth.\footnote{Alice Amsden. “Diffusion of Development: The Late-Industrializing Model and Greater East Asia,” American Economic Review, 81.2, 1991: 282-286.}

Sender (1999) argues that the sub-Saharan African countries that followed Washington consensus policies closely and were described as “core adjusters” by the World Bank actually fared worse than others that did not adhere to the policies as rigidly. Similarly, the countries that were described as “recent strong performers” by the IMF for the period over 1990 to 1995 have shown lower investment to GDP and private investment to GDP that the average for the region.\footnote{John Sender. “Africa’s Economic Performance: Limitations of the Current Consensus.” Journal of Economic Perspectives, 13.3 (Summer 1999): 89-114.}

In light of this empirical evidence against the Washington consensus, Dani Rodrik (2000a) shakes off the idea of finding similarities among countries’ development experience altogether; he says that the essence of development policy should not be finding common ground between economic systems around the world, but to pay attention to local needs. According to him, “the Augmented Washington Consensus is bound to disappoint, just as its predecessor did. There are many things wrong with it. It is an
impossibly broad, undifferentiated agenda of institutional reform. It is too insensitive to local context and needs. It does not correspond to the empirical reality of how development really takes place. It describes what ‘advanced’ economies look like, rather than prescribing a practical, feasible path of getting there. In short, the Augmented Washington Consensus is infeasible, inappropriate, and irrelevant.” He thus suggests the following four propositions about economic reforms and growth:

1) Transitions to high economic growth are typically sparked by a relatively narrow range of policy changes and institutional reforms.

2) The policy changes that initiate these growth transitions typically combine elements of orthodoxy with unconventional institutional innovations.

3) Institutional innovations do not travel well.

4) Sustaining economic growth is a challenge in itself, and cannot be taken for granted.

Institutions have complementarities associated with them, so that orthodox reforms in China would have been too ambitious and prolonged. The imaginative shortcuts taken by the Chinese reformers sidestepped the complementarities that might have ruined a partial or gradual approach. Rodrik (2002b) further adds that the paradox of markets is that, unless they have reached an advanced stage, they thrive not under laissez faire, but under government supervision. Although markets require non-market institutions to function, the institutional basis of markets is not unique, as China’s reform strategy demonstrates.

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• **Part III: Economic Reforms. Chinese Style**

To understand China’s growth, we first need to take a closer look at the country’s post-reform growth. Table 1 shows us the sources of growth in China. This tells that the growth cannot simply be attributed to the growth of the physical capital stock: human capital stock and TFP also grew at an average annual rate of 2.69 percent and 2.32 percent annually between 1978 and 1999 and accounted for 13.80 and 23.90, respectively, of average annual GDP growth.

<table>
<thead>
<tr>
<th>Table 1: Sources of Economic Growth in China</th>
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<td>(in percent)</td>
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<td>Pre-reform period</td>
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<tr>
<td><strong>Average Annual Growth Rate (%)</strong></td>
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<tr>
<td>Output</td>
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<td>Physical Capital Stock</td>
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<td>Labor Quantity</td>
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<td>Human Capital Stock</td>
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<td>TFP</td>
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<tr>
<td><strong>Contribution to GDP growth by factor</strong></td>
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<tr>
<td>Physical Capital Stock¹</td>
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<td>Labor Quantity¹</td>
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<td>Human Capital Stock¹</td>
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<td>TFP²</td>
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¹ Ratio of input growth weighted by the corresponding factor income share, to GDP growth.
² Ratio of TFP growth to GDP growth.

From the development point of view, one also needs to look at the welfare implications of this growth. Chen and Ravallion (2001) define a “growth incidence curve” that shows how the growth rate of income per head for a given quantile varies across quantiles ranked by income. The curve is strictly increasing over all quantiles, implying an increase in income inequality. The annualized percentage increase in income per capita is estimated to have been about 3 percent for the poorest percentile and 11 percent for the richest. While income became more unevenly distributed in the 1990s, there was an increase in overall well-being of the average Chinese citizen: between 1978 and 1998, 200 million people
have been lifted out of poverty; per capita income has increased at an average annual growth rate of 7 to 8 percent; and life expectancy has increased by 10 years.\textsuperscript{21}

![Figure 1: Growth Incidence curve for China, 1990-1999](image)

Additionally, although the growth has been unevenly distributed across China, the regional disparities are often exaggerated: when we measure income growth of the 30 provinces individually, we discover that 20 of those provinces had faster per-capita income growth rates than any other country in the world since 1978.\textsuperscript{22}

\textsuperscript{21} Stiglitz (1998b): p. 1
\textsuperscript{22} Ibid. (One must immediately concede that this observation overlooks rural-urban discrepancies. However, it undermines the misconception that growth has been limited to the southern coast of the country; the 20 provinces mentioned are spread across the country.)
We can now turn to China’s institutional development to assess the extent to which this economic performance is explained by institutional reforms. Burki and Perry (1998) attempt to find the relationship between institutional development and economic growth using a composite institutional index based on subjective measures provided by the International Country Risk Guide (ICRG). They use five indicators to measure institutional development: (1) the perceived risk of expropriation of property, (2) the perceived degree of contract enforceability, (3) the extent to which there are mechanisms for peaceful dispute-resolution or the perceived degree of the rule of law and order, (4) the perceived quality of public bureaucracies, and (5) the perceived incidence of corruption in government.

Figure 1.1a above shows the fitted line from a simple linear regression. This method is not satisfactory since growth is determined by factors other than institutional development. To deal with this problem, figure 1.1b is based on the estimation of the partial correlation coefficient between growth and

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23 It is important to note that the five indicators might be correlated with each other, and with other indicators of institutional quality and political stability.
the composite index of institutional development. The impact of institutional development on growth is thus isolated.

In both cases, China is an outlier; the analysis implies that China has grown more than it should have given its institutional development. Institutional economists consider the conventional wisdom of transition focusing on stabilization, liberalization, and privatization inadequate, since it misses the important institutional dimension. However, the weakness of the post-Washington consensus thus becomes apparent. China is deemed to be a growth anomaly given its institutional development. This discrepancy arises because institutional development does not necessarily have to conform to a textbook definition. Since institutional arrangements are the means to the ends of sustained growth, China’s institutional innovations addressed economic and political concerns simultaneously.

To understand how China has managed to sustain such high growth rates for two decades, we need to look at the institutional innovations that have acted as substitutes for best-practice institutions. It would be best to divide China’s reform era into two periods: “reforming the system” (1979-1993) and “replacing the system” (since 1994).25

Reforming the System (1979-1993)

During the first period, China did not establish uniform rules or international best practice institutions as we know them. Although best practice institutions would have been more efficient, the failure of the big-bang reforms in Russia and Eastern Europe showed that the complementarities associated among institutions would have made it extremely difficult to sequence the reforms properly or to bear the political costs associated with them.26 The partial reforms introduced in China were successful in unleashing the standard forces for growth: positive incentives, hard budget constraints, and

26 Hellman (1998) says that costs associated with big-bang reforms result in a J-curve effect: economic conditions deteriorate in the immediate wake of reforms, and only begin to improve after a considerable lag. We will discuss how such a J-curve effect was avoided in China later in our analysis.
competition, but in extremely unusual ways. The important characteristic of these transitional institutions is that they were compatible with the existing conditions in China in 1978.

1) Regional Decentralization of the Government

Although China de jure is a unitary state, it functions de facto as a federalist state in many ways; this arrangement has been called “Federalism, Chinese Style.” As early as 1979, local governments supervised about three quarters of the state industrial firms in terms of output and were responsible for most state industry and infrastructure investment. Consequently, not only did local governments directly control township and village enterprises (TVEs), but they were also responsible for the provision of public goods. Also, local governments played an important role in attracting foreign investment into their localities: the share of foreign investment administered by provinces as opposed to central ministries increased from 35 percent in 1985 to 68 percent in 1992.

This regional decentralization of the Chinese state is of a multi-layer-multi-regional form mainly based on a territorial principle—the “deep M-form” economy, or in short, the “M-form” economy. This hierarchical structure has several advantages over the unitary form based on the functional or specialization principles (the “U-form” economy) that existed in Russia and Eastern Europe. Instead of several branches of a state planning commission overseeing individual sectors of the economy in a U-form economy, the M-form economy is characterized by local supervision of all sectors of the economy that fall in the jurisdiction of individual provinces. Such an arrangement allows for a unique arrangement: the advantages of both central planning and inter-regional competition are thus realized.

**Experimentation and Imitation:** An important advantage of regional decentralization is that it allowed experimentation at the local level and the results then being used elsewhere. For instance, the household responsibility system, whereby each household agrees to give a fixed quota to the local government and gets to keep the rest of the output, was first introduced only in Fengyang County of

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28 Montinola, Qian, and Weingast 1995: p. 61
Anhui Province in 1978, a time when the rest of China was still under the collective farming system. The success of this arrangement led to imitation by other locales; by 1984, almost all farm households across China had adopted this system.  

Similarly, special economic zones (SEZs) were first established in 1980 only in four localities—Shenzhen, Zhuhai, Shantou, and Xiamen. Not only were many such zones established later, but several practices experimented with inside these zones, such as new accounting methods and employment practices, were adopted elsewhere. In 1984, such rights were extended to 14 coastal cities that were declared “coastal open cities.” In the early 1990s, the privileges of special economic zones were made available in some inland regions, for instance cities along the Yangtze River.

Local government as developmental state: Another advantage of devolution is based on the information advantage of decentralization, as suggested by Hayek (1945); since local governments have a greater understanding of local needs and conditions, they are better suited to the provision of public goods than the central government. Regions responsible for their finances have the incentive to promote local economic activity. Specifically, the “market-preserving federalism” theory propounded by Montinola, Qian, and Weingast (1995) argues that such an arrangement aligns government interests with the promotion of investment and competition in regions. This financial incentive for local governments became particularly stronger after the fiscal contracting system was introduced in 1980 under which local governments entered into 5-year contracts with the central government for paying fixed revenues and retaining 100 percent at the margin.

Using provincial panel data between 1982 and 1992, Jin, Qian, and Weingast (1999) found a correlation coefficient of 0.75 between marginal budgetary revenue collection and marginal budgetary expenditure. They also found that greater fiscal incentives, in the form of higher contractual marginal

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30 Qian (1999a), p. 8
revenue retention, were associated with faster growth of non-state enterprises and more reform in state-owned enterprises. This relationship implies that the greater resources were spent for stimulating investment within the region through better public services and infrastructure. While the theory of incentives spurring efficiency has long been common knowledge, Jin, Qian, and Weingast’s (1999) findings actually show that infra-marginal revenue actually results in greater infrastructure spending by local governments thus resolving the common development problem of state predation of economic activity. This situation contrasts starkly with the “grabbing hands” of local governments in Russia that were regarded as predatory towards private businesses.34

**Competition for factors of production:** Although the measures of the so-called floating population vary, it is significant by any measure and thus threatens the stability of individual regions and the country as a whole. Since labor moves from area of surplus to area of need, some provincial authorities have attached great importance to organized labor export to other regions. For instance, total labor export from Sichuan province has reached 3 million per year and remittances from migrants have totaled 3-5 billion yuan annually, which is ten percent of net farmer income in the province. Once regions are responsible for their own economic welfare, there is competition among regions that have a surplus of labor to export the surplus labor; similarly, there is competition among regions facing labor shortages to attract adequately skilled workers from elsewhere.35

**Competition for foreign capital:** There is fierce competition among regions—provinces, townships, cities, SEZs, and development zones—for foreign capital. This competition takes two forms: providing better infrastructure, such as transportation and port facilities and access to markets; and introducing investor-friendly laws, regulations and tax rates.36

Initially, economists strongly criticized this regional decentralization. Public finance specialists believed that such an arrangement distorted resource allocation, fostered regional disparity, jeopardized

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36 Montinola, Qian, and Weingast (1995): p. 73
regional cooperation, and undermined the central government’s fiscal policy. While some of these disadvantages may have had a negative impact, the advantages accruing from greater incentives and regional experimentation apparently outweighed the costs.

2) Entry and Expansion of Non-State (Mostly Local Government) Firms

The growth of the non-state enterprises is an important characteristic of China’s reforms; between 1978 and 1993, the share of the non-state sector increased from 22 percent to 57 percent of industrial output. This growth happened without any privatization of SOEs and was entirely the result of fast entry and expansion of new non-state enterprises.

Private enterprises played only a minor role in the initial reform period; in 1993, they contributed to less than 15 percent of national industrial output. The most important contributors were the TVEs that contributed 72 percent and 58 percent to rural industry output and employment respectively in 1993.

TVEs were unpopular initially because they were neither privately owned nor state owned per se. Therefore, economists believed that such an arrangement would not be able to exploit the advantages that accrued to private firms in the form of greater competition nor those accruing to SOEs in the form of government support—access to information networks and easy credit. However, the success of the TVEs may be attributed to their compatibility with the imperfections of the institutional environment of China in the form of insecure property rights and imperfect capital markets.

**Insecure property rights:** In the absence of secure property rights, the community government plays a crucial role in protecting TVEs. Such guarantees were essential because private business was often attacked in China, for example during the “anti-spiritual campaign” of 1983, the “anti-bourgeois liberalization campaign” of 1987, and in the wake of the Tiananmen Square massacre of 1989.

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37 Before describing the nature of industrial reform in China we must clarify that the state sector refers to SOEs, while the non-state sector refers to privately owned and local government owned enterprises.
39 Qian (1999a), p. 11
40 Che and Qian (1998a), p. 2
41 Che and Qian (1998a), p. 12
Qian (1998b) contend that under such circumstances, it is beneficial to have the local government provide public goods and control the TVEs. When the local government has a direct stake in the profitability of the TVEs, it preys less on the TVEs and the management does not fear the government either. Indeed the entire community has a stake in the profitability of the TVEs: in 1985, about 46 percent of after-tax profits of TVEs was reinvested and 49 percent was used for local public expenditure, including 12 percent for welfare; in 1992, 59 percent of after-tax profits of TVEs was reinvested and 40 percent was used to finance local public expenditure, including 9 percent for welfare.43

TVEs have thus been able to overcome the absence of property rights. The key is not merely ownership, but control; while stakeholders act as shareholders in China, in Russia, where formal property rights were introduced, shareholders had no control so entrepreneurial activity suffered.44

**Imperfect capital markets:** Additionally, since capital markets were not developed in China, TVEs had advantages in financing investment compared to private enterprises. Local governments used their influence in the banking sector to secure finances for TVEs. Banks also considered TVEs more creditworthy than private enterprises that were subject to political whims. Even on economic grounds, the fact that the local government could cross-subsidize among its diversified enterprises reduced the risk borne by banks. Such an arrangement further reduced the risk faced by banks because investment supervision by the local government reduced information asymmetry compared to the case where banks funded unorganized private investments.45

While it may be argued that the aforementioned advantages accruing to TVEs are attributable to state ownership in general, it is highly unlikely that such an arrangement would have been feasible at the national governmental level in a country such as China. More importantly, however, TVEs were confronted with hard-budget constraints and free-entry, while SOEs operated in the comfort of soft-budget constraints and monopoly rights. Similarly, it might be objected that it might have more profitable

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43 Che and Qian (1998a): p. 7
44 Rodrik (2004): p. 21
45 Qian (1999a), p. 13
simply to encourage private firms and then raise revenue by taxing them. However, due to the situation existing in China, it was not feasible to introduce private property immediately; other complementary institutional arrangements were missing and would have taken too much time to be introduced. Che and Qian (1998b) also argue that when local governments have ownership rights, it is cheaper to extract revenue than it would be through taxing private firms. This assertion is supported by Jin and Qian (1998), who found that a one percent increase in the share of TVEs relative to private enterprise is associated with a 0.11 percent increase in the shares of revenue accrued to the national government and a 0.24 percent increase in the shares of revenue accrued to the local governments.46

**Hard budget constraints:** A very important factor responsible for the success of the TVEs was the hard-budget constraints imposed on them. Since there was freedom of entry within a region, TVEs faced a constant threat of competition that drove them to efficiency. Further impetus was added by the fact that the local governments had gained credibility of not bailing out floundering TVEs: in 1989, for example, about 3 million TVEs went bankrupt or were taken over by other TVEs.47

**Dual incentives:** The compatibility of TVEs with China’s institutional environment is testified by the fact that an increase in the share of TVEs in the industry of a region is positively correlated with the level of central government revenues accruing from the region and with local government revenues.48 In this manner, both the central government and the local government had an incentive to encourage the growth and development of TVEs. Thus the success of TVEs became a self-fulfilling prophecy.

3) **Financial Dualism**

“Financial dualism” is the third pillar of institutional reform in China (Bai et al. 1999). There are two aspects of financial dualism. The first concerns government revenue. Government tax revenue as a share of GDP declined from 31 percent in 1978 to 13 percent in 1993. Taking into account extra-

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48 Jin and Qian, p. 11
budgetary and off-budgetary revenues, total tax revenue also declined dramatically from 40 percent of GDP in 1978 to about 19 percent in 1993.\footnote{Off-budgetary and extra-budgetary revenues primarily comprise of retained profits of TVEs and SOEs.}

But this decrease was partially compensated for by an increase in quasi-fiscal revenue from financial deepening. Cash in circulation as a percentage of GDP was less than 6 percent in 1978, and increased to about 16 percent in 1993. The ratio of total household bank deposits to GDP rose from 6 percent in 1978 to about 50 percent in 1993 and 62 percent in 1997. The M2 to GDP ratio also increased substantially from less than 50 percent in 1993 to above 100 percent in the 1990s.\footnote{Chong-En Bai, David D. Li, Yingyi Qian, and Yijing Wang, “Anonymous Banking and Financial Repression: How Does China’s Reform Limit the Government’s Predation without Reducing Its Revenue?” Mimeo, Stanford University, 1995, p. 3} The government was able to benefit from this financial build-up; Bai et al. (1999) estimate that between 1986 and 1994, the government collected quasi-fiscal revenue, in the form of seigniorage and implicit taxes on deposits, from the banking sector averaging 9 percent of GDP, or more than half of the budgetary revenue.\footnote{Bai et al. (1999), p. 34}

The fiscal-decline-cum-financial-deepening had greater implications than just government revenue. The coexistence of two institutional arrangements in China’s financial system rendered this arrangement extremely advantageous. The first is the case of “financial repression” by the government—a combination of control on international capital flows with restriction on domestic interest rates and private financial activities. The second is the unusual arrangement called “anonymous banking”—a combination of permission to carry out cash transactions and to use anonymous household savings deposits. Given the conditions in China, revenue extraction from financial repression is more advantageous than direct taxation.\footnote{Bai et al. (1999), p. 33}

This seems counter to conventional wisdom; reducing transparency through such an arrangement facilitates corruption. But North (1997) argues that most development and transition economies suffer from a serious commitment problem: since governments find it difficult to credibly commit themselves to fixed rates of taxation, private business suffers because of the uncertainty associated with this situation. In

\footnote{Bai et al. (1999), p. 3}

\footnote{Bai et al. (1999), p. 1}
China’s case, it is important to consider the importance of political economy and the government’s commitment problem. Anonymous banking limits the government’s predatory activities and creates private incentives. Due to this “information decentralization,” the government does not know the identity of depositors and is unable to target anyone. Although the government can still “tax” financial savings through inflation and interest rates, such methods are indiscriminate. For political stability, the government is more limited in its revenue collection than it would be under discretionary taxation. In this manner, the government is able to achieve credible commitment in the absence of conventional institutions, such as the rule of law and the separation of powers.\(^{54}\)

Real name household deposits have been introduced from April 1, 2000. This change will curb corruption. Opposition to such a move has been mitigated by only applying the change to new bank accounts; existing accounts remain anonymous. Again, this dual-track allows for a smooth transition.\(^{55}\)

In addition to the incentives given to the private sector under such an arrangement, the government does not suffer either: since implicit taxation on bank deposits is greater than zero, government revenues do not fluctuate much either.\(^{56}\)

The other aspect of financial dualism concerns the lending side of the financial system, which was skewed so that SOEs received more credit from state banks and thus faced softer budget constraints than nonstate enterprises. For example, in the late 1980s and early 1990s, SOE output was twice TVE output, but loans to SOEs accounted for 86 percent of total non-agricultural loans while those to TVEs accounted for just 8 percent.\(^{57}\)

The government may actually find it advantageous to allow the existence of two sectors: a well-monitored—state-owned—sector that pays more taxes, receives more credit, and is more capital intensive, but has lower incentives due to soft budget constraints; and a less-monitored—non-state—sector that pays fewer taxes, receives less credit, and is less capital intensive, but has higher incentives

\(^{54}\) Bai et al. (1999), p. 2
\(^{55}\) Qian (2002): p. 42
\(^{56}\) Ibid.
\(^{57}\) Qian (1999a), p. 16
due to hard budget constraints.\textsuperscript{58} This unusual arrangement had its advantages. First, the hard budget constraints on the nonstate sector spurred efficiency, allowing the economy to “grow out of the plan.”\textsuperscript{59} Second, the government was able to maneuver the political situation according to its needs. The government considered SOE employment a political priority over nonstate employment because the SOEs were mostly located in urban areas that are more politically labile than rural areas.

4) Dual Track Market Liberalization

Unlike Eastern Europe, China took a gradual approach to price reform. Under the “dual track” approach, prices were first liberalized at the margin while (inframarginal) planned prices and quotas were maintained and then phased out. This approach achieved a balance between stability and incentives. Under the plan track, agents were assigned rights to and obligations for fixed quantities of goods at fixed plan prices. To supplement this arrangement, a market track also existed so that economic agents could participate in the market at free market prices after they fulfilled their obligations under the pre-existing plan. Besides maintaining stability, the dual-track approach allowed markets to emerge.

Further, the welfare implications of this approach make it an attractive option. Lau, Qian, and Roland (2000)\textsuperscript{60} argue that the approach both allows liberalization without creating losers and can achieve efficiency under certain conditions. They maintain that regardless of initial supply and demand conditions such as whether plan prices and output are above or below the market equilibrium levels, the dual-track approach is always Pareto-improving. This is because the existence of the plan track ensures the protection of status quo rents under the existing plan, while the market track allows those who participate in it to be better off. The approach also achieves efficiency under usual conditions such as profit maximization and perfect competition, if market resales and market purchases for redelivery are allowed. Since the compensatory transfers are inframarginal and lump sum in nature, the dual-track approach can

\textsuperscript{58} Bai et al. (1999), p. 29
be efficient too; sufficient incentives exist to make this possible because of the existence of infra-marginal rents.\textsuperscript{61}

Another advantage of the dual-track approach is that it utilizes existing information and institutions, so that the reform process is not disruptive.\textsuperscript{62} Therefore, instead of bearing the hardship of a drop in output followed by an increase in output later under the so-called J-curve effect, the market is able to make a smooth adjustment that culminates in the gradual reduction in the relative size of the plan track. For instance, under the dual track, the state procurement of domestically produced grain remained fixed between 1978 and 1988, while grain output increased by one-third.\textsuperscript{63} Table 2 shows a similar trend in retail sales: transactions at plan prices became a smaller and smaller proportion of total retail transactions.

\begin{table}
\centering
\begin{tabular}{lrrrrrr}
\hline
\hline
Transactions at plan prices & 97.0 & 47.0 & 35.0 & 33.7 & 28.9 & 31.3 & 30.0 \\
Transactions at market prices & 3.0 & 53.0 & 65.0 & 66.3 & 71.1 & 69.7 & 70.0 \\
\hline
\end{tabular}
\caption{Dual Track in Retail Sales (Percentage of Sales)}
\end{table}

\textit{Source:} Lau, Qian, and Roland (2000), p. 140
\textit{(Original source: China Reform and Development Report (1992-93), p. 54)}

\textbf{Problems}

This analysis seems to suggest that this first stage of reforms based on institutional innovation did not face any problems. Despite the overall success, some serious problems did arise. First, the decentralization of government was abused in the realm of monetary policy: the local governments exercised so much influence over the local branches of the central bank that bank bonuses were linked to the amount of credit they extended. This became a source of inflation and soft budget constraints on the government. Qian and Roland (1998) argue that monetary decentralization has created problems because with the externality of inflation, each local government receives the full benefits of monetary expansion

\begin{flushright}
\textsuperscript{61} Ibid. \\
\textsuperscript{62} Lau, Qian, and Roland (2000): p. 122 \\
\textsuperscript{63} Qian (1999a), p. 19
\end{flushright}
but shares the costs of inflation with other regions. Thus budget constraints on local governments are softened.\textsuperscript{64} The inflationary pressure in the economy in the early 1990s may be seen in the figure below.

![Graph showing GDP and RPI over time](image)


Second, since the temporary institutions were introduced to counter the absence of important institutions, many difficult reforms were delayed. For instance, in the initial phase, no SOEs were privatized and the 1986 bankruptcy law was never enforced. Similarly, formal property rights were not introduced either. Although the absence of the best-practice institutions was not direly felt at the time, the country's overall performance might have been even stronger if an effort were made to use the transition institutions to make a transition as soon as it was feasible instead of letting complacency set in.\textsuperscript{65}


\textsuperscript{65} Qian (1999a), p. 21
Replacing the System: Since 1994

Qian (1999a) says that since 1994, China’s reforms have entered a second stage. This does not imply that the reforms have picked up pace since then, or priorities have changed radically. However, the success of the first fifteen years of reform made it clear that in order to take the reforms further the country had to establish a rule-based market economy that was grounded on conventional best-practice institutions. Therefore, the ruling Communist Party officially changed its ideology to establish a market system and private property, even though the initial target was not a market economy. It was able to make this change because the first fifteen years had succeeded in creating momentum for reform so that enough people had a direct stake in the success of further reforms. The breakthrough occurred when the “Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure” was adopted by the Third Plenum of the Fourteenth Party Congress in November 1993.66 The groundbreaking document emphasized a clear reform strategy, a rule-based system, building market-supporting institutions, and property rights and private ownership.67

The Decision, as it has come to be known, had several important characteristics. First, unlike the experimentation-based approach earlier, after the Fourteenth Party Congress, the importance of coordination among various aspects of reform was emphasized by the government. Thus a coherent package and sequence of reforms emerged.

Second, while the first stage of reforms made use of particular contracting arrangements, such as fiscal contracting, managerial contracting, and household contracting, the Decision called for a rule-based arrangement. Consequently, foreign exchange rates and tax rates were unified among all enterprises regardless of ownership.

Third, the Decision advocated the creation of market-supporting institutions, such as formal fiscal federalism, a centralized monetary system, and a social safety net. Consequently, revenue transfers between the central and provincial governments were based on a determined formula and not subject to

66 China Daily, Supplement, November 17, 1993
67 Qian (1999a), p. 23
constant changes through bargaining as was the case before. Additionally, the operation of the central
bank was centralized to reduce intervention by local governments.

Finally, the Decision also made it clear that SOEs were in of reform, which entailed the existence
of property rights and private ownership. So some of the smaller SOEs were privatized or shut down.
However, the issue lingered longer than was perhaps originally foreseen.

Despite the implicit recognition of private ownership by the Decision, private ownership and the
rule of law were formally incorporated into the Chinese constitution in March 1999. Immediately after
the amendment, local governments adopted a more explicitly friendly approach towards private business.

In hindsight, it is difficult to imagine that the Chinese Communist Party initiated the reform
process itself, especially because in the wake of the failure of economic reforms in Eastern Europe, it was
postulated that perhaps democratic reform must precede economic reform to ensure the success of the
latter. However, the Chinese case showed that adroit handling of the reform process meant that everyone
had a stake in the reforms' success. These circumstances allowed China to pursue some of the difficult
reforms as it tried to replace the old system. We can now discuss the five major achievements of the
reform process since 1994.

1) Unification of foreign exchange rates and convertibility of the current account

Until 1994, liberalization of foreign exchange markets followed a dual-track approach; there was
an official rate and a market rate for foreign exchange. The market track grew more rapidly than the
official track since so many international transactions were conducted by Chinese and foreign based
enterprises. Consequently, by 1993, the share of the plan allocated foreign exchange had fallen to less
than 20 percent of the total. This relative decline of the plan in the foreign exchange market made it easier
to abolish the plan allocation of foreign exchange on January 1, 1994. To ensure a smooth transition, the
organizations used to receiving cheap foreign exchange were given lump-sum subsidies to enable them to
purchase the same amount of foreign exchange at the new rate for a period of three years. In December
1996, China also announced the current account convertibility of its currency. However, it desisted from

68 China Daily, March 16, 1999
capital account convertibility and this allowed China to remain relatively unaffected during the Asian financial crisis.⁶⁹

2) The overhaul of the tax and fiscal systems

Although fiscal contracting had played a positive role in China’s reforms until 1994, the arrangement was ad hoc. The tax and fiscal reforms of January 1, 1994 changed this situation and made the Chinese system more rule-based through the introduction of national and local tax bureaus. In this manner, a fixed rule for sharing VAT between national and local government in the ratio of 75:25 was initiated. This change actually increased the amount of revenue that local governments had to pay to the center. However, to ease the transition process, local governments were compensated for their losses for the first three years after the reform.⁷⁰

In addition, the new Budget Law was introduced in 1995. It was an attempt to enforce fiscal discipline on the central and local governments. The central government could not finance deficits on its capital account, but could finance deficits on its current account with government bonds. The law also imposed restrictions on local governments: a cap was placed on local governments’ bond issuance and borrowing in the financial market. An independent auditing system ensured transparency with the establishment of the State Auditing Agency in 1996.

3) Monetary centralization and financial reform

Qian and Roland (1998) say that one of the mistakes of the first wave of reforms was monetary decentralization, which led to inflationary pressure and soft budget constraints on local governments. Before 1994, 70 percent of the state bank loans were made by local branches, but all operations were centralized thereafter, with Premier Zhu Rongji himself at the helm of the central bank. Thus local governments lost influence on monetary policy and credit allocation. This allowed the state to enforce hard budget constraints: in 1998, some high profile banks and investment companies, such as the Hainan

⁶⁹ Qian (1999a): p. 27
Development Bank and Guangdong International Trust Investment Company, closed down or went under. Such high profile closures allowed the government to gain much needed credibility.\textsuperscript{71} In addition, a nationwide credit crunch has been in effect since 1993, bringing down inflation from over 20 percent in 1993 to about 2 percent in 1997.\textsuperscript{72}

4) **Downsizing of the government bureaucracy**

Reforming the government bureaucracy is an integral part of institutional reforms during transition. During the first fifteen years of reform, the basic government bureaucratic structure was kept intact. In early 1998, a major reform for streamlining the government was introduced. Most industrial ministries were replaced by bureaus that were absorbed into the State Economic and Trade Commission. In the end, the number of ministries was reduced from 45 to 29, and the number of civil servants from 8 million to 4 million. The laid off civil servants were compensated by getting access to cheap housing and gaining the right to enroll in undergraduate and graduate degrees for free.\textsuperscript{73}

To improve the efficiency of the military, police, and the judiciary, entrepreneurial activities by these branches were banned and an emphasis was placed on the transparency of their actions. These organizations then began to rely solely on tax revenues to finance their operations.

5) **Privatization of state-owned enterprises and layoffs of state workers**

Due to the political costs associated with the reform of the SOEs, China did not privatize any SOEs or layoff any state workers before 1992 and only began to accelerate the reforms of the SOEs in 1995. Even after a decade and a half of successful reforms, in 1994, China had 300,000 SOEs (including 100,000 in industry) with about 75 million state employees (including 43 million in industry).\textsuperscript{74}

In 1994, China began a quiet reform in privatizing and restructuring its SOEs under the slogan “grasping the large and letting go the small.”\textsuperscript{75} The program had a three-pronged agenda: (1) privatization of small SOEs at the county level; (2) mass layoffs of SOE workers at the city level; (3) mergers,

\textsuperscript{71} Qian (1999a), p. 29
\textsuperscript{72} Qian and Roland (1998): p. 23
\textsuperscript{73} Qian (1999a), p. 30
\textsuperscript{74} Cao, Qian, and Weingast (1999): p. 1
\textsuperscript{75} Ibid.
corporatizations, and initial public offerings (IPOs) of some large SOEs under state supervision. Thereafter there was privatization of small SOEs at the county level and mass layoffs of SOE workers at the city level. So the policy was to hold on to the approximately 1000 largest SOEs—that account for 40 percent of total assets, 51 percent of net assets, and 66 percent of profits in the state sector—and to privatize the small and medium-sized ones, which were about 95 percent of all SOEs in number, 57 percent in employment, and 43 percent in output.\textsuperscript{76} By the end of 1996, up to 70 percent of the small SOEs had been privatized in pioneering provinces and up to 50 percent in other provinces. In addition, about 10 millions workers were laid off in 1996 and another 11.5 million in 1997.\textsuperscript{77}

To make these layoffs politically feasible, the government uses one of two institutions: \textit{xiagang}—“stepping down from one’s post”—or \textit{zaijiuye}—“reemployment program.” Under \textit{xiagang}, laid off workers continue to receive some compensation from the government, while under \textit{zaijiuye} they are given other jobs.\textsuperscript{78}

The incentives for such radical reforms are grounded in the M-form hierarchical structure or “federalism, Chinese style;” since the budget constraints on local governments have been tightened, they do not want to bear the burden of inefficient SOEs. Thus political opposition to the reforms is reduced.

\textbf{The Future of the Reforms}

Despite the impressive progress China has made both in reforming its system and replacing parts of it, there are some issues that will pose challenges to the future of the country’s reforms.

\textit{The financial system:} The first area of concern is the financial system. Although China’s financial system successfully mobilized savings and provided the government with quasi-fiscal revenues, the fundamental institutions remain primitive and weak. The biggest concern is the burden on the banking system in the form of non-performing loans. At the end of 1999, household savings reached RMB 6 trillion, more than 280 times the 1978 level. These savings are the principal source of bank lending.

\textsuperscript{76} Ibid, p. 6
\textsuperscript{77} Ibid, p. 2
\textsuperscript{78} Ibid, p. 3
the end of 1999, loans outstanding from all financial institutions reached RMB 9.4 trillion, over 110 percent of GDP and well over the 50 percent ratio of lending to GDP in 1978. Moreover, total non-performing loans were estimated in the range of 17-25 percent of GDP in 1993 and in the range of 25-35 percent of GDP in 1997.\textsuperscript{79} Such a burden is not sustainable and is thus an area of concern for policymakers. Since the banks in China are state-owned, their bad debts are simply government debts. By the end of 1998, explicit government debts were 10 percent of GDP. This imposes a large fiscal burden on the government. Although the government still has the instruments of fiscal repression at its disposal to reduce the burden of its debt because these bad debts are domestic debts, there is still a need for reform sooner rather than later.

Lau and Qian (1994) suggest that the government should distinguish between the stock problem of the debt and the flow problem. Since the stock has already been accumulated over the years, the focus should be on the flow problem since it affects future expectations and behavior. This problem can be solved by addressing the SOE situation. Since 1998, the Chinese state banks have reduced lending to large loss-making SOEs and shifted their priorities to more efficient small and medium-sized non-state enterprises. Another source of encouragement is the emergence of competition from foreign banks.

A proposed solution to the impending banking crisis is to use asset management companies to recover as much as possible through a combination of liquidation, auction, securitization, sale of equity, mergers, and private placements of acquired assets. Although such companies can be modeled on the Resolution Trust Company in the United States, China lacks comparable institutions in the form of pension funds, mutual funds, and insurance companies, as well as a developed bond market.\textsuperscript{80}

**SOEs and corporate governance:** Related to the reform of the banking sector, is reform of SOEs and corporate governance. This has perhaps been the most disappointing area of reforms in the Chinese economy. The managerial contract responsibility system promoted in the 1980s had limited success, and SOE performance continued to decline in the 1990s. For instance, one-third of SOEs were making losses

\textsuperscript{79} Lardy (1999): p. 2  
\textsuperscript{80} Lardy (1999): p. 6
in 1996, and average profits and taxes per unit of capital stock and working capital fell from 24.2 percent in 1978 to 12.4 percent in 1990 and further to 6.5 percent in 1996.\textsuperscript{81} Even though the share of SOEs in industrial output has been falling and small SOEs have been privatized, large SOEs still need to be privatized since they are a major burden on the financial system.

Usually the SOE’s inefficiency is attributed to welfare obligations. However, the real problems concern the soft budget constraints and personnel appointments by the Party rather than on merit. The Central Party Organization Department has authority over appointments of managers of the large SOEs. This applies to joint-stock companies as well as long as the state is the majority shareholder. Such a process results in appointments based on political networks rather than ability.

According to Qian (1996), the problem is not as simple as it seems: giving more autonomy and authority to managers creates agency problems, while maintaining direct Party control results in high political costs. The solution, therefore, lies not in complete autonomy or greater Party supervision, but in a combination of corporate governance and depoliticization. Under such an arrangement, managers would be accountable to the state or to the shareholders, be forced to follow clearly established and transparent corporate practices, and have a stake in the effective management of the enterprises.\textsuperscript{82}

Despite political interference being the major obstacle to effective corporate governance, there is no doubt that the welfare burden on SOEs also makes it difficult to reduce political and agency costs. SOEs have been burdened with “social responsibilities” in five ways: (1) redundant workers; (2) retirement pensions; (3) medical care; (4) housing; and (5) other social services such as nursery and elementary school. Political and agency costs can be reduced through a desocialization of the SOEs—that is, by unbundling the social responsibilities by providing welfare security for employees outside the workplace.\textsuperscript{83} 

\textbf{Rule of law:} The third major problem, establishing the rule of law, is related to enforcing transparent corporate practices. One serious problem undermining private incentives in China has been

\textsuperscript{81} Qian (1999a) p. 38  
\textsuperscript{82} Qian (1996)  
\textsuperscript{83} Qian (1996): p. 18
insecure private property rights. Although the Communist Party would never want to relinquish control over all aspects of society, it must create a level field that treats the state and private agents equally. Doing this without undermining its hold on society has proven to be difficult. Most important is the creation of an independent and uncorrupted judiciary, which seems impossible under a one-Party system.
• Part IV: Conclusion—Beijing Discretion

China was able to push the reforms through using a “divide and rule” strategy. In other words, since the reforms were gradual and sequential in nature, only a small segment of the population opposed the reforms at any point in time. In this manner, the government tried its best to pacify the losers of the reforms as much as possible, before initiating a new phase of reforms. Therefore, a sequential reform strategy has the advantage of building constituencies and momentum at the interim stage. But such an approach entails the existence of a stable government.

Dewatripont and Roland (1992) also argue that when faced with dynamic political constraints in the presence of informational asymmetries, governments can use gradualism in the shrinkage of outdated industries and sectors to ensure the political optimality of the reform path. For this reason, the big-bang approach advocated by the IMF and the World Bank for reforms in Russia and Eastern Europe would not have been the optimal strategy even if agency problems were sufficiently curbed.

One needs to understand political constraints in order to formulate an effective reform strategy. According to Hellman (1998) most reform policies, especially the more radical ones, are based on an analysis of the costs and benefits of reform that conforms to a J-curve: economic reforms generate transitional costs in the short run before they begin to produce their promised economic gains. If the government cannot make a credible commitment to the population that the promised benefits will be forthcoming, it is in fact rational to oppose the reforms ex ante. Therefore, political decision makers need to be protected from public pressure until a strong enough constituency in favor of the reforms emerges.

However, opposition comes from the losers and also from the winners; from the winners’ perspective, the J-curve is reversed: their earnings rise in the short run, but fall in the long run as they distortions introduced by the partial reforms are removed. Thus the winners prefer to seize the partial or

gradual reform process in some intermediate stage where their rents are maximized. To be in a position to take the reform process further, both the losers and the winners must be taken into account.

This partial reform trap was avoided in China because not only were the losses widely spread out to reduce opposition, but benefits from reforms were also well-dispersed. Such an approach was not inspired solely by egalitarian concerns; spreading out the benefits of the reforms meant that the winners had a stake in further reform. For instance, the dual track price liberalization preserved old rents and at the same time set a cap on the marginal rents accruing to participants in the market track. Consequently, the winners had a stake in the complete liberalization of prices.\textsuperscript{88}

Contrary to expectation, China’s reforms succeeded without complete liberalization, privatization, or democratization. China did not fit into the general description of “From Plan to Market: World Development Report 1996” (World Bank, 1996). This is precisely the problem with the Washington consensus approach: the desire to fit every set of policies and every approach into a mould. Montinola, Qian, and Weingast (1995) argue that China’s reforms continue to confound analysts who insist that economic reform is not sustainable without political reform. This is because their definition of political reform is too narrow.\textsuperscript{89} Although other reforms such as popular democratic elections would be best way for the government to gain credibility, at this stage, such a drastic measure is not feasible, or desirable, for the Chinese Communist Party. Consequently, federalism might be one of the best ways in which a large, undemocratic state can provide credible limits on its behavior.\textsuperscript{90} Such an arrangement also places a limit on patronage systems and political spoils. Kornai (1998) has also emphasized that democracy is not a necessary basis of a market system but a political power that is friendly towards private property and free markets is.

Cao, Qian, and Weingast (1999) argue that “privatization, Chinese style, rests on an adequate economic and political foundation—federalism, Chinese style.” At any one time, reforms are characterized by a “horizontal non-uniformity”: regions are pursuing different reforms in different sectors.

\textsuperscript{89} Montinola, Qian, and Weingast (1995): p. 51
\textsuperscript{90} Montinola, Qian, and Weingast (1995): p. 75
before emulating the successes and learning from the mistakes. Therefore, there is also a "vertical non-uniformity," with different regions pursuing reforms in different areas, at different levels of government: agricultural reforms began at the household level; TVEs at the village and township level; privatization of SOEs at the county level; layoffs of state workers at the city level; and marketization at the provincial level.\textsuperscript{91}

The Chinese experience thus supports the four propositions about economic reforms and growth made by Rodrik (2002a).\textsuperscript{92} First, the reform process never involved a big-bang phase; instead the reforms were always gradual. Second, as we have seen, innovation to achieve standard results such as greater competition has been at the core of the reforms. The third point is more subtle and is consistent with the uniqueness of the Chinese experience. The Chinese could have emulated the developmental state model used effectively by Japan and South Korea, but, according to Hausman and Rodrik (2002), the Chinese state simply did not have the institutional capacity to do so. Finally, the Decision of 1993 showed that even after achieving initial success, the Chinese reforms could not follow the same pattern. The changes in the reform strategy emphasize the point that development policy is a dynamic and not a static phenomenon.

This pattern also reflects the fundamental change in the state’s attitude towards economic policy. Under Mao, the central government forced reforms on all regions regardless of whether the reforms were suited to the region and of whether they would work in the first place or not. That “one size fits all” approach is what underlies the core of the Washington consensus that Beijing’s discretion since 1978 has exposed as mistaken: not only must development policy vary across countries, but even across regions and over time within a country. This is perhaps the most vital lesson that other transition and developing economies can learn from Beijing.

\textsuperscript{91} Cao, Qian, and Weingast (1999): p. 25
\textsuperscript{92} (1) Transitions to high economic growth are typically sparked by a relatively narrow range of policy changes and institutional reforms; (2) The policy changes that initiate these growth transitions typically combine elements of orthodoxy with unconventional institutional innovations; (3) Institutional innovations do not travel well; (4) Sustaining economic growth is a challenge in itself, and cannot be taken for granted.
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