

INTRODUCTION

ECONOMIC REFORM IN CHINA

James A. Dorn

China's reform process has both mass and acceleration. A collision of reform and special interests must come with great force at some point in time.

—Steven N. S. Cheung

The Collision Course

The momentous changes occurring in China support Steven Cheung's concern with the collision course of economic liberalization and the incentive of China's nomenklatura, or ruling elite, for maintaining the status quo. Over the past decade China has made significant progress in transforming its bureaucratic system of state planning into a more market-oriented economic regime. The agricultural reform, in which individual farmers were given more effective ownership and control rights over the land at their disposal, saw a flourishing of activity in the countryside. Agricultural production increased dramatically and the newly created wealth spilled over into the formation of thousands of small-scale private enterprises producing a variety of products. Nevertheless, the dynamism that has characterized the agricultural sector has been largely absent in trade and industry, where the state continues to hold sway over economic life.

The persistence of state-owned enterprises and the lack of competition in trade and industry have hampered economic reform in China. The inefficiency of state enterprises has led to a vast network of subsidies,¹ and the deficits of state enterprises have been financed

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¹In 1988, subsidies to state-owned enterprises amounted to nearly \$11 billion—a figure representing about 50 percent of the earnings of China's industrial enterprises (South-erland 1988, p. F5).

to an increasing extent by bank credits. The resulting inflation, now in the range of 20–30 percent, is seriously eroding support for further economic liberalization. But the real culprit is the iron grip the state still has on all important aspects of economic life and the refusal of the elite to bow to the forces of the marketplace.

The Failure of Piecemeal Reform

The current situation in China points once again to the failure of piecemeal reform and especially to the impossibility of establishing viable markets and prices without ownership reform and the establishment of private property rights. In particular, a sound constitutional framework, which insulates economic life from political opportunism, appears as a necessary condition for social and economic stability in China. The current corruption that is splitting China at the seams really stems from the ruling elite's vast power over economic and personal freedoms. Ultimately, economic and political reform are inseparable. As long as a Chinese wall surrounds the ruling elite—preventing the free flow of market information and the free expression of ideas—the quest for economic and social stability will fail to be realized.

At the heart of China's chaos, then, is a massive government failure: namely, the failure to establish an effective constitutional framework limiting the power of government officials over the economic and social life of the nation. The problem of how to curtail the influence of special interests and move the economic reform forward, while at the same time satisfying the demands for greater political freedom, is a classic issue in public choice theory. The rent seeking that characterizes democratic governments in the West, and which stems from an erosion of the economic constitution of liberty (as discussed in the writings of F. A. Hayek and others), is widespread in China where the rule of law has been supplanted by the rule of men.

When enterprises are owned and controlled by the state, economic decisions necessarily become political decisions, and impersonal price competition is supplanted by forms of personal competition driven by the quest for political power and privilege. Bribery and corruption then become the rule rather than the exception. The resulting uncertainty surrounding economic transactions acts as a destabilizing influence on economic development. This predicament has clearly been true of China's mixed economy as it has tried to force itself free from the grip of the nomenklatura, who have so far refused to decontrol markets and prices in a large segment of China's vast economic landscape.

Constitutional Order and Economic Order

The problems of implementing a market-oriented reform in China and the prospects for transforming China's "ossified order" of state planning into a vibrant open society were the focus of the Cato Institute's conference on **Economic Reform in China: Problems and Prospects** held last September in Shanghai and cosponsored with Fudan University. The papers in the first part of this volume focus on the interconnection between constitutional order and economic order, and point to the difficulty of instituting price reform without ownership reform.²

With Hong Kong reverting to Chinese control in 1997, the path that China now follows will set up expectations that will shape the transition of Hong Kong. Any deviation from a market-oriented reform and an increased degree of freedom will destabilize the transition process and lead to economic and social chaos. The essays in this volume offer various proposals for achieving economic and social stability in China, and point to the importance of establishing constitutional safeguards for economic and personal freedoms. The privatization of state-owned enterprises and the introduction of competitive markets to replace state monopolies may appear radical to Chinese conservative leaders; but where it has been tried in Special Economic Zones (SEZs), the success has been resounding. The challenge now facing China is whether to continue on a piecemeal reform and suffer the fate of earlier Soviet and Eastern European reforms or to institute thoroughgoing ownership and price reform, thereby enhancing the prospect of achieving a spontaneous market order that could make China an economic giant in the next century.

The essays here draw from experience in the West, in Hong Kong, and in the Pacific Rim—and utilize recent developments in constitutional economics and public choice theory—to offer China guidance in mapping out a path toward long-lasting stability and prosperity. A major lesson is that economic order and stability ultimately require a constitution of liberty, in the Hayekian sense. Self-interest can then be harnessed for the wealth of the nation rather than deteriorate into a rent-seeking society. Experience has proven that private property, freedom of contract, and basic political freedoms are the indispensable basis for a dynamic economic order, and that information is best utilized via decentralized markets and prices.

²The complete set of conference papers will be published in the United States by the University of Chicago Press and in China by Fudan University Press. The forthcoming book is entitled *Economic Reform in China: Problems and Prospects*, coedited by James A. Dorn and Wang Xi.

China's experiment with central planning is now judged a dismal failure by virtually everyone. The coordination of over one billion people cannot be accomplished by social engineering, without a great loss of freedom and prosperity. The free-market order, grounded on a rule of law, offers an alternative to secure the freedom and prosperity desired by the Chinese people. These basic desires cannot long be suppressed without increased corruption and inefficiency. Thus, the real issue facing China is not whether reform is necessary but how fast and how far to go. As Zhao Ziyang stated: "Without reform there will be no way out for China. If reform is not carried out today, it will have to be carried out in the future, but that will only prolong China's backwardness."³

References

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³Quoted in Abrams (1988, p. 15C).