Privatization vs. Special Interests: The Experience of China's Economic Reforms

Steven N. S. Cheung

In the span of 10 years since China opened her doors to the world, economic changes have taken place of a magnitude and speed that are simply awesome. Remembering what China was like a mere decade ago, we are compelled to think that her declared growth statistics, impressive though they certainly are, must be understated. Whatever the future holds, the recent Chinese experience will be remembered as one of the most significant economic events in history.

In 1981, I predicted China would go "capitalist" (Cheung 1982). With the single exception of Ronald Coase, all my friends objected that this judgment was far too optimistic. My prediction, stated in no uncertain terms, was that China, although probably never officially endorsing "private property," would nonetheless adopt a system akin to private property in practice.

Not even modesty can now suppress a temptation to claim perspicacity. Unfortunately, recent events confirm another judgment call I made three years ago: The easy part of China's economic reforms was coming to pass, and high hurdles that could not be overcome without bold actions would soon follow.

Outsiders and Chinese authorities alike identify the same baffling difficulties. Mounting inflation is coupled with ever-rising government spending. The government finds price controls increasingly difficult to finance, yet to relax them without a sharp rise in the wages of state employees beyond the government's budget constraint may lead to social unrest. This view of a two-sided problem is not wrong. However, I shall argue that the root of the difficulties lies in the

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deeply entrenched state-controlled monopolies designed to protect vested interests.

In this paper I begin with a brief discussion of China's success in promoting private property rights in land and in labor. I then turn to the difficulties likely to face any attempt to privatize state enterprises. Finally, the relationship between these issues and the current headline topics of China's inflation and financial problems will be considered.

The Creation of Private Property via Contracting

Whereas it has taken a revolution to abolish private property, the process in reverse may be done through peaceful contracting. It is not clear whether authorities in China were aware that the end result of the agricultural reforms initiated at the turn of the decade, is, for all practical purposes, a system of private property rights. Certainly the word "private" was avoided like a plague until March 1988. But as it turns out, the so-called responsibility contract, with all its modifications and refinements, is a Chinese version of the deed of trust.

"Responsibility" means that an individual household, or a set of households, assumes the task of production and payment to the government. In principle, the state imposes few additional restrictions, although in the industrial and business sectors numerous interventions remain. The development of the responsibility contract, with its attendant obstacles as well as implications for resource allocation, deserves a thorough study beyond the scope of this paper. It suffices here to quote from my 1986 "Postscript" to *Will China Go 'Capitalist'?* to pinpoint its nature (Cheung 1986, p. 67).

> The so-called "responsibility contract," if reduced to its simplest and therefore most perfect form, is equivalent to the granting of private property rights through a state lease of land. The duration of the lease may be any number of years or, in principle, it may be in perpetuity. Ownership is not relinquished by the state, but the rights to use and to obtain income are exclusively assigned to the lessee. The right to transfer or to sell the leased resource may take the form of sub-letting. Various dues exacted by the state may be lumped together in the form of a fixed rent, and since this rent is paid to the state it becomes a property tax. If indeed a perpetual lease is assigned, the land-holding becomes fee simple, and if the lease is freely transferable, the land is held in fee simple absolute—or private property in its perfect form!
>
> In ancient China, as in medieval Europe, there was no distinction between the meaning of "rent" and of "tax." A feudal lord who collected "rent" became a collector of "tax" when he assumed the role of a "government" in providing services such as justice and

> protection. From this point of view, the evolution of the responsibility system in China has come close to repeating in three astonishing years the course of several centuries of development in medieval Europe.

Yes, the responsibility contract as applied in agriculture comes very close to what in the Western world is a grant of private property in land. The clear, if minor, departure is that the Chinese version takes the form of leasehold instead of fee simple; that is, the contract is not in perpetuity. The length of the responsibility contract varies considerably across different regions or for different types of crops, and there is a tendency for contracts of a more recent vintage to have longer terms. In some regions, local authorities stipulate no time limitation at all: Confidence in the leasehold therefore varies with political climate. With the passage of time the contract holders gradually assume the view that they have an implicit perpetual right.

The use of the leasehold method finds its counterpart in Hong Kong, where practically all land belongs to the Crown. Although in this and in other developments in China the influence of Hong Kong is unmistakable, there is no doubt that a contract falling short of a deed serves a vital political function. With a leasehold the ownership of land remains with the state, thereby excluding private property in title and permitting the preservation of an image of socialist ownership. Early on, the transfer of the contract—equivalent to selling land—was forbidden as a way to suppress capital gain, but even this restriction has been relaxed and in some localities it is entirely ignored.

The public auction of land for nonagricultural uses, which occurred for the first time on December 1, 1987, also falls short of fee simple. Here again the exclusion of outright sale preserves the title of state ownership. Yet in a true economic sense private property in land had been created, and with the recent explicit allowance of capital gain, not only Karl Marx has been forgotten but also Henry George. Significantly, in a public auction in Shanghai in July 1988, a Japanese firm was the winner. For the first time since the communist revolution, a foreigner had openly gained a private interest in China's soil. We may suppose the protection of private property of land will be generally strengthened: With any degree of foreign participation, any backward step is likely to have broader repercussions.

The establishment of private property rights in labor is even more prevalent than in land, although it has received much less attention. Unlike land, which itself makes no decision, every worker is a decisionmaking unit. Therefore, as soon as the government relaxes its control over labor, the individual would automatically assume responsibility for himself. In other words, labor becomes private property the moment it is not manipulated and controlled by the government.

The privatization of labor became evident about five years ago, when the authorities relaxed the requirement that all employment be assigned by the state. The unemployed (described as "waiting to be employed") were far too numerous, and the pressure from Hong Kong investors to hire labor by private contracting was far too great. The experiment of letting state employees take their chances with the market began in the Pearl River basin and gradually spread northward. Today, the state control of labor still found in Beijing is nonexistent in Southern China.

Individual households running their own small enterprises can now be found everywhere, and in Southern China even state-owned enterprises now refuse to hire state employees; rather, they opt for contract workers. In the South, the survival of the state-employee system in trade and industry is sustained by only three factors. First, state employees have guaranteed security and retirement benefits. Second, contract workers employed by state enterprises are subject to wage ceilings. And third, with most sizeable enterprises still owned by the state, employment opportunities are limited. Still, in a number of localities, particularly in areas where Hong Kong investors are popular, the state-employee system is quite literally falling apart.

Difficulties Confronting Trade and Industry

By 1985 the responsibility contract was well established in agriculture and China began to extend the system to state-owned enterprises in trade and industry. I noted in 1986 five problems encountered in trade and industry (Cheung 1986, pp. 68–69):

> First, productive assets such as a desk, a machine, a brand name, or know-how are not physically divisible like land, so the productive assets in a corporation are not owned exclusively by any specific member of the corporation. With many individuals working in a group, as in a typical state enterprise in China, rights over productive assets obviously cannot be delineated in the way lands are divided among individual peasant households. In the absence of any clearly delineated exclusive rights, the collective holders of a responsibility contract are, not surprisingly, prone to argue over the division of the income generated by their joint efforts.
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> Second, virtually all productive assets other than land tend to have finite usable lives. Depreciation of equipment and buildings might be thought to justify the government laying down the amount of re-investment, the kind of goods to be produced, and the type of business that must be maintained. In deciding these matters, conflicts of interest arise between the government and the joint holders

> of responsibility contracts. Of course, there is simply no way the government could be expected, in a wide diversity of trades and industries, to rival the wisdom or expertise in decision-making of those actually engaged in the enterprise.
>
> Third, the production process in trade and industry is generally far more complex than in agriculture. Contracting, sub-contracting, and sub-sub-contracting are common, and these have led to responsibility arrangements in complex, multi-stage forms. When the holders of an original responsibility contract—responsible directly to the government—sub-contract to others, the terms of performance and the division of income are difficult to negotiate because both the contractor and the sub-contractor lack the option of refusing to cooperate and of seeking competitive bidding elsewhere. Further, the government often wants to maintain a say over the terms of sub-contracting.
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> Fourth, because of changing market conditions, profits and losses fluctuate more sharply in trade and industry than in agriculture. Responsibility contracts therefore tend to have a much shorter life (typically one year). Holding to the labour theory of value, the government tends in renewing contracts to increase or reduce its "take" depending on the results of performance, and contractors who have performed above expectations naturally feel unjustly deprived of any reward.
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> Finally, productivity in trade and industry, far more than in agriculture, depends on the quality of human capital. An entrepreneur with creative ideas may be worth a fortune, but his innovation cannot be fully rewarded within the short duration of a responsibility contract. Indeed, a prime target for common condemnation of the responsibility system is the average wage ceiling of 250 RMB (about US$50) per month, imposed both to effect a desired distribution of income and to force an increase in investment.

I argued that to tackle these problems, three requirements are in order (Cheung 1986, p. 70):

> First, state ownership of depreciating productive assets must be relinquished, either to the highest bidder or simply as an endowment to members of the existing state enterprise. This must be done because these assets, or their values, unlike land, will disappear in time.
>
> Second, if several or many individuals own the assets, shares should be issued against the asset value and assigned to the individuals. If necessary, this division of wealth might be done by voting, as baseball players in the United States vote to divide the income from the World Series.
>
> Third, the shares must be freely transferable.

Of these recommendations, the only one the authorities remain reluctant to accept is the first, namely, relinquishing state ownership of depreciating assets. The impression I obtained at the time is that for political reasons state ownership of resources must be preserved. That is, private property may be practiced in nature, but not in name, and this dichotomy is far more easily resolved in agriculture than in trade and industry.

In September 1987, therefore, I suggested to my Beijing friends a new solution that, following Mao's terminology, may be called a "thorough" responsibility system. Thinking of a private individual borrowing from a bank to buy an automobile in the United States, in which the legal owner (the bank) and the registered owner (the individual) are separate, I proposed that the assets of a state enterprise be assessed and converted into a monetary value. The state would then "loan" this capital value to the individuals running the enterprise, with dues in the form of interest payments. The state would relinquish all controls as long as interest payments were met. With the issuance of transferable shares, the nature of private enterprise will be practiced while preserving the legal title of state ownership.

My proposal would have worked perfectly if the only concern were to preserve the image of a socialist system. There is no inherent conflict between the economic nature of private property and socialism. (After all, each individual is a social entity.) However, recent events suggest that the real problem of reform in trade and industry does not rest so much with the preservation of an image, or what the system should be called. Rather, the main problem lies in something most of us working on the theory of the state have known all along, namely, the protection of privileges associated with special rights. And it appears that special interests are far more easily defended in trade and industry than in agriculture.

Why Price and Wage Controls?

As early as 1981, I predicted that in China's movement toward private property, the last and most stubborn redoubt standing in the way of reform would consist of those state enterprises in which monopoly can be maintained most easily. This observation has become self-evident.

In agriculture and in household enterprises, competition is severe, and it is difficult for special interest groups to protect their rights. Similarly, in industries such as hotels, restaurants, or handicrafts in which entry is free, special rights dissipate readily with the onset of competition. A state-owned hotel surrounded by private hotels must follow what the market dictates or face defeat. The right to control is valueless if competitors are exempt from that control. In China there

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is no question that businesses subject to open competition have blossomed.

On the other hand, it is to be expected that sectors such as public transportation, public communication, utilities, petroleum, and mineral rights will not readily go private. But the list does not end there. Banking, foreign exchange, international trade, the steel industry, products with successful trademarks, and industries with trade secrets or with effective barriers to entry such as heavy machinery, drugs, and silk are all candidates for persistent state manipulation and control because of their monopoly status.

Authorities in charge of these monopolistic industries benefit from price and wage controls. From price control, the officials with the right to allocate or ration goods, along with those who have special rights to receive them, stand to gain at the expense of government subsidies as well as costs to consumers. From wage control, workers' income is reduced in favor of those in command.

While price and wage controls are easily enforced with state ownership, they are difficult in the case of private enterprise. For example, if fish is sold in a state-operated market in which profit and loss are not the concern of anybody, it can literally be marked at any price. But an individual who gets up before dawn, rides a bicycle to the village to buy a few fish with his own money, and then rushes back to sell in the market is likely to grow violent if a government official tries to restrict his pricing.

It is easy to give reasons for controls: wage control to promote a desirable income distribution; price control to check inflation, to assist the needy, to encourage industrial development, and so on. These justifications are both trite and wrong, but they are used routinely all the same. Even in our modern times, politicians seem to be running out of imagination.

The Chinese experience is the most telling. State ownership of monopolistic ventures is maintained because it is relatively easy to do so, and with state ownership, price and wage controls are relatively easy to enforce because no private party has a vested interest to object, and these controls generate income to individuals with special rights.

Supporting evidence is strong. Domestic plane tickets used to be sold at one-third the market price, allowing privileged officials to preempt blocks of them for sideways dealing. However, sometimes planes would fly almost empty. Steel for construction work is sold at less than half the market price, allowing those with the right to ration to capture handsome "rents." It is absurd that at a time when the whole of China requires rebuilding, the import of rebars is severely restricted. The foreign exchange rate (a price) is "controlled," so to speak, but special exchange centers are officially allowed to deal at near black market rates. That is, black market foreign exchange dealing is prohibited for private citizens, but not for government officials. The interest rate (again a price) is pegged at a level far below the rate of inflation. The result is that households or small state-owned enterprises cannot hope to borrow money, while officials with proper connections borrow to relend subtly, to invest carelessly, or to consume lavishly. And the list goes on.

A Collision at Last

We are all aware that proponents of market-oriented reforms in China have had their fair share of opposition. Yet with numerous reports of political infighting, China's progress has been so fast that it would have been unthinkable only a decade ago. We have felt all along that vested interests cannot be dismissed lightly, that there is no pay-off or buy-out which can be conveniently executed, and that a free-enterprise economy cannot be developed without bold actions. A reform program that benefits the society at large does not mean all its members will benefit. Some special interests, somewhere, somehow, will have to bear the cost of change.

On a number of occasions I have pointed out that China cannot remain long at this balance point without turning into another India. The Indian syndrome of government regulations, state-controlled monopolies, and massive corruption is certainly seen in China today. But unlike India, China's reform process has both mass and acceleration. A collision of reform and special interests therefore must come with great force at some point in time. From an optimistic point of view, it is a relief that this collision comes so soon. Yes, what China will turn out to be depends on what will happen in the next two or three years.

Observers concur on what they see. China has mounting and near runaway inflation; officials or state employees of ordinary status find their purchasing power declining with sticky wages. To print more money means more inflation. Yet inflation is apparently fueled less by increases in the money supply than by tight control of interest rates. With these rates being pegged significantly below the rate of inflation, people have a strong incentive not to hold renminbi (RMB). But to let the interest rate float would mean decontrol in a vital government monopoly.

As my whole argument implies, since price control exists primarily in state-owned monopolies, the freeing of prices would strip down the rights of the privileged groups. Furthermore, so long as enterprises are owned by the state, increased prices will not lead to increased production of goods and services as would be the case with private enterprise.

In 1988, Deng Xiaoping and Zhao Ziyang announced that it was essential for price controls to be bulldozed away. Their statement was bold and admirable. Some prices have since risen sharply, including those of liquor, cigarettes, and plane tickets. Unfortunately, the coverage does not extend to interest rates and exchange rates—which hints at powerful vested interests in these areas. It is equally regrettable that taxes, dues, and duties have also been increased. The great *sine qua non* now is to set right the fundamental source of the difficulties. China's deep and basic needs now are the privatization of state-owned enterprises and the demolition of state-created monopolies.

The Nature of the Problem

China has reached a point where piecemeal tactics are not likely to be effective in advancing her economic reforms. During the past decade such tactics have served China well, often brilliantly. While cadres and citizens alike agree that the "common rice wok" and the "iron rice bowl" are detrimental to productivity and must be discarded, they have little understanding of how a market system based on private property rights operates. With the Marxian doctrine nearly dead, there was, and still is, an ideological vacuum in China. The piecemeal approach thereby adopted is impressively pragmatic, using common sense rather than theory to correct the economic ills that have become all too evident. Indeed if any people can be called experts on the shortcomings of a communist system, the Chinese have no peers. Piecemeal tactics guided by common sense and the economic forces at work have, by and large, been the policy guideline for one decade. And in spite of the political opposition and occasional backslidings that have often occupied news headlines, progress has been phenomenal.

In the process, a substantial number of comrades have lost their privileged status. The more astute ones have turned to trade and industry and do well because of connections. Others have become ordinary citizens or have gone into retirement. In areas subject to intense competition, previous hierarchical rights based on rank regardless of productivity have become valueless. In other areas, however, these privileges are transformed into monopoly and regulation rights. An attempt to protect a state monopoly or to protect a regulation is an attempt to protect "a right."

I can cite numerous instances to support this view. But if we must single out one example of prime importance, then the financial sector would be a natural choice because of the wide ranging implications involved, and because its problems make the headlines almost every day.

Take Wenzhou for instance, where any impartial observer must stand in awe of its economic success. A number of small private savings-and-loan institutions cropped up to finance small businesses, with brilliant success. But this booming enterprise was soon restrained by the banking authority, which imposed interest and licensing regulations. Again, in the area of foreign exchange, it has been a monopoly long enjoyed by the Bank of China, reaping handsome profits through exchange controls and rationing. But when black market activity became prevalent and hard to control, the authorities themselves started exchange centers dealing in near free-market rates. It is difficult to say in what sense exchange control now exists in China. Certainly all arguments in favor of it have been flatly contradicted by the government's own behavior.

Indeed the pattern is replete that where competition is severe and monopoly power can hardly be maintained, the authorities routinely opt for a freer market and more private property protection. But where monopoly is protected, the policies adopted always tend to benefit special interest groups and, along with price and wage controls, the superiority of socialist ownership is again upheld as unquestionable.

Nothing can be further from the truth. The arguments for freer markets and for the necessity of maintaining controls, often heard from the same authorities, reveal such glaring contradictions that one must infer that the prime motivation of controls is to benefit privileged groups. There is no conceptual difference among the monopoly and controls in silk, steel, heavy machinery, foreign trade, foreign exchange, and banking. The problem is general, although inflation and the difficulty of feeding state employees (as well as students) are placed in the spotlight, they tend to obscure the nature of the problem.

Monopoly protects; state ownership facilitates controls; the right to control generates income to the privileged. This is as true in the production of goods and services as in the banking and financial sectors, although the latter has broader implications for the economy as a whole. The piecemeal tactic of decontrolling a few prices, of restraining the growth in money supply, or of curbing government expenditure does not get to the heart of the matter. A general problem calls for a general solution: Privatize state enterprises and allow free entry for all.

Conclusion

It is somewhat puzzling that the currently reported 25 to 30 percent annual increase in the money supply of RMB could have caused a near 30 percent annual rate of inflation. A number of localities in China have experienced real growth rates in excess of 25 percent per year, and goods and services that were previously self-consumed or bartered are now transacted in the marketplace. These things are not recorded in the official statistics. Still, one may argue that a 15 to 20 percent monetary growth per annum would be more appropriate. However, I surmise that the current inflation in China is prompted mainly by controls on interest rates, by government restrictions on savings-and-loans or small private banks, by the fact that even major foreign banks are not allowed to perform the essential functions of banking, and because output in state-operated enterprises are not elastic to increases in price.

The financial difficulties of China so often discerned are real. But how are these possible? How is it possible that a nation with citizens now rushing to buy gold has more financial problems than when they could not even afford to buy vegetables? Why should the Chinese government now find it necessary to impose heavy taxes on practically everything, as compared to the earlier starvation period when taxes were unheard of?

No, China should not have any financial problems at all. She has all the "lands under heaven" to sell, all the mineral rights to sell, numerous state enterprises to sell, and an army of officials who could be relieved and turned to more productive employment. If these things are done, China would have a budget surplus with a tax system as simple as that of Hong Kong, and even at lower tax rates.

More fundamentally, therefore, my view is that whereas the formation of private property via contracting has been relatively smooth in areas subject to active competition, the process fails when it comes to areas where monopolies are fostered. It is time for China to consider the creation of private property by mandate. And whereupon they may follow one simple rule: For state-owned resources that are salable, sell. This is the most straightforward way to create private property, and the selling prices as well as the forms of payments may be adjusted as special cases demand—in the initial sale to distribute and define property rights, the market price need not be applied. The proceeds may be used to compensate individuals who suffer greatly from the changes, to invest in the infrastructure (or better still, to loan out to private parties for such investment), and above all, to establish a judicial system based firmly on the principle of equality before the law.

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THE DEPOLITICIZATION OF ECONOMIC LIFE IN CHINA

James A. Dorn

Steven Cheung has written a very interesting and thought-provoking paper. He sees the state monopoly of trade and industry, with its bureaucratic overhang, and the lack of an effective legal system as major barriers to China's continued economic development. The source of the so-called Chinese headache, according to Cheung, is the failure to depoliticize economic life—that is, to overcome powerful special interest groups who continue to oppose thoroughgoing price reform and the privatization of state enterprises. Not surprisingly, the Chinese puzzle is the same as that facing other socialist nations, namely, how to insulate economics from politics.

The Preservation of Privilege and Chaos

When ownership and control rights are lodged in state monopolies run by political operatives who are not subject to the profit/loss test of competitive markets, economic decisions necessarily become political decisions. The status quo then becomes the norm, and privilege, not competence, determines "who gets what." Such is the case in state-owned enterprises that dominate trade and industry in China.

A rule of law protecting persons and property is essential for a vibrant economic life. The lack of a sound legal system safeguarding property rights and freedom of contract has hampered the formation of competitive markets and prevented the emergence of a rational price system in China. The Chinese wall that surrounds the nomenklatura in trade and industry has prevented the free flow of information that is essential for economic harmony.

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By disallowing market forces from freely determining the movement of prices and the allocation of resources, political competition has overruled the impersonal competition of the market price system. And by disallowing private ownership of enterprise assets, the linkage between individual action and responsibility has been weakened. The vacuum left by the absence of the disciplinary force of bankruptcy, by the lack of transferable shares reflecting future value consequences of current resource usage, and by the fact that managers of state-owned enterprises have no exclusive right to residual income has been filled by a pervasive bureaucracy having vast economic empowerments. In such a system, political considerations inevitably clash with rational economic decisionmaking.

What has emerged is a welfare system for government monopolies—in which the costs of inefficient resource usage are socialized by an extensive system of subsidies—and a redistributive state writ large. By failing to separate the political and economic regimes, China has become a rent-seeking society in which national wealth is dissipated in a struggle for power and privilege. The disease affecting Western democracies, in which the rule of law has been eroded, is at epidemic proportions in China's state-controlled sector. To survive in a politicized economy means to cater to political preferences rather than to consumers' preferences. In such an environment, reform is difficult and corruption is a predictable trait of economic life.

When the Chinese nomenklatura stand to lose their privileged position as the economy is decentralized, they will present a formidable force against economic reform. As long as the economy is driven by politics, it is rational from the perspective of the ruling elite to retain rigid control over the use and disposition of enterprise assets. And as Cheung notes, it is also rational to set prices below market-clearing levels—since this tactic provides greater discretion for those in control to determine who gets what and allows them to enhance their personal wealth by buying low and selling high, either in the black market or in the open market if there is a two-tier pricing system.[1] Within China's closed society, the elite and their families and friends stand to benefit at the expense of the public at large. The much heralded equality under state ownership and socialism is therefore more of a myth than reality.

Examples of corruption within China's state-controlled sector abound and provide additional support for the hypothesis that managers of socialist enterprises can be expected to shirk more often than

[1]Cf. Alchian (1967, p. 13) who has argued that the attenuation of private property rights provides an incentive "to charge prices below market-clearing levels more frequently."

managers of private for-profit firms.[2] Cheung points to cases in the airline industry, steel, and foreign trade where officials have used their "right to ration" for personal gain. In a similar vein, Julia Leung (1989, p. A12) observed that often the monies used to prop up inefficient state enterprises are wasted "on grandiose construction projects, inappropriate equipment, and fancy state housing" or find their way into the pockets of "corrupt officials." Again, the basic problem, writes Leung, is "the failure . . . to distance government from the running of enterprises."

Two other examples reinforce the corrupt nature of state ownership and control over economic life. Dorinda Elliott (1988, p. 42) calls attention to the practice by which "scalpers, called 'yellow cows' in Shanghai, buy up cheap state-subsidized goods direct from the factory—often by bribing the plant manager—then sell them at premium prices to consumers." And in a recent article in the *Far Eastern Economic Review*, Ellen Salem (1988, p. 22) observed that "the shortage of raw materials and the state monopoly on supply in certain instances all but force managers to bribe officials to get whatever they need." Thus, it is not surprising that a recent survey by the Chinese Academy of Social Sciences (CASS) found that 83 percent of China's urban population believe China's nomenklatura engage in corrupt practices. What is surprising, at least from a Westerner's viewpoint, is that the same survey found that 63 percent of the nomenklatura admitted they were corrupt.[3]

Typically, those who oppose economic reform lay the blame for widespread corruption on the liberalization of markets and prices rather than on the government's failure to depoliticize economic life by divesting the nomenklatura of their control over enterprise assets. Thus, in trying to discredit the economic reforms, Radio Shanxi used the market system as a straw man, arguing that corrupt practices were the result of "the corrosive influences of the decadent capitalist ideology."[4]

[2]For a survey of some of the relevant literature on managerial behavior in socialist enterprises, see Furubotn and Pejovich (1972, pp. 1154–57). The key point is that the absence of capitalization and residual claimancy in state-owned enterprises means that socialist managers will have less incentive to engage in profit-maximizing behavior than managers of private for-profit firms. The rewards for efficient behavior in socialist firms are narrowly limited and the probability of failure is dampened by state subsidies. On the other hand, as Alchian (1967, p. 12) has emphasized, the "marketability" of shares in private firms "implies *capitalisation* of future effects on to present values. Thus, long-range effects are thrust back on to the current owner of the marketable value of the goods." As such, private owners "will heed the long-run effects of current decisions more carefully than if the rights were not transferable."

[3]The survey results are reported in Salem (1988, p. 22).

[4]Quoted in Salem (1988, p. 22).

The locus of failure, however, lies with the state not the market. As Cheung and others have recognized, it is the state's monopoly over trade and industry, the piecemeal approach to price reform, and the absence of private property and freedom of contract that are the fracture points in China's economic landscape. As long as the state holds most of the economic empowerments—so that special rights and privileges are extended to the nomenklatura—corruption will continue.

Moreover, as long as the state controls the bulk of economic resources and supports inefficient enterprises, the incentive to finance the deficits of state-owned enterprises directly through bank credits will remain a threat to China's social and economic stability. The current inflation rate, estimated at more than 20 percent per annum, has already given cause for slowing ownership and price reform. Without monetary stability, more secure property rights, and free-market prices, it will be impossible for China to realize its full potential for economic and social development.

The vesting of ownership and control rights in the state bureaucracy has prevented real markets from developing in a large part of the Chinese economy. It is the lack of constitutional constraints on government and the absence of a private property framework for markets and prices that concern Cheung. In the absence of a constitutional anchor holding the state at bay and a competitive price system rooted in effective private ownership, vested interests will remain in power. The anticipated result will be corruption and chaos. Thus, until the depoliticization of economic life occurs, the spontaneous market order that has been the characteristic feature of open competition and private property will fail to appear in China.

In sum, the absence of a sharp delineation between political life and economic life in China has led to a privileged class that has the power to control economic levers. The persistence of the Chinese nomenklatura in trade and industry has slowed economic reform, led to inconsistent prices, and increased uncertainty. The current chaos in China's economic life, therefore, is due in large part to the nomenklatura's refusal to extend private ownership and competitive pricing to trade and industrial enterprises where state monopolies prevail. More fundamentally, it is the refusal of those in power to insulate economics from politics that lies at the heart of China's difficulties. As Hua Sheng and two other economists from the CASS recently noted, the current corruption and inflation in China can be traced to the "failure to separate political power from economic management." In their opinion, "The Chinese economy today is, to a significant extent, manipulated by political power."[5] To free trade and industry from the inefficiency and disorder associated with the present regime, Cheung proposes radical institutional reform.

The Privatization of Trade and Industry

The Chinese wall surrounding the nomenklatura must be broken if trade and industry are to be freed from the fetters imposed by the privileged class. For Cheung, piecemeal tactics will not work, neither will the extension of the so-called contracting system to state monopolies. What worked so well in agriculture will not work in trade and industry because of the entrenched bureaucracy and lack of competition, argues Cheung. "China's deep and basic needs now," writes Cheung, "are the privatization of state-owned enterprises and the demolition of state-created monopolies."[6] Only in this way can China's economy open to the competitive forces that will ensure its long-run survival in an increasingly interdependent world economy.

Thus, although Cheung previously advocated an indirect approach to creating effective ownership in state enterprises, he now calls for a more direct approach. In particular, he argues that "It is time for China to consider the creation of private property by mandate." To do so, he proposes a simple and straightforward rule: "For state-owned resources that are salable, sell."

Cheung's privatization scheme is meant to crack the back of the nomenklatura and to open trade and industry to the forces of the marketplace. For once property is in private hands, incentives will operate to drive out inefficient producers and reward those who satisfy market demands at competitive prices. When the government is no longer an intermediary in most economic transactions, buyers and sellers will find it easier to arrange mutually beneficial exchanges without the added cost of bribing public officials and the uncertainty of bureaucratic discretion.

The exact terms of each sale of government property are less important to Cheung than privatizing state-owned enterprises as quickly

[5]Hua Sheng, Zhang Xuejun, and Luo Xiaopeng as quoted in "China Reforms Said Snarled by Politics" (1989, p. A9).

[6]Cf. Hua, Zhang, and Luo who have argued that the only way to end the corrupt practices associated with the state's monopoly over the material supply system and to ensure the success of China's market-oriented reform is to strip state officials of their monopoly power. Referring to the nomenklatura who control the state supply system, Hua and his colleagues argue: "They have shown no scruples about illegal speculation or taking bribes" and "must be stripped of their monopoly." Like Cheung, these economists believe that "a genuinely market-oriented reform requires the state to cede its power and responsibility in almost all economic fields." Quoted in "China Reforms" (1989, p. A9).

as possible in order to deprive the nomenklatura of their special rights and privileges. Moreover, Cheung suggests that part of the proceeds from privatization be used to help compensate those individuals who are significantly harmed by the institutional change. Such a strategy could help ease the transition process by breaking down some of the resistence to privatization. The main point, however, is that the divestiture must take place by mandate; otherwise it will not occur because of the strong resistance by special interests.

If China's leaders really want to achieve thoroughgoing reform, they will have to recognize two basic ideas that Warren Nutter (1968, p. 144) so aptly expressed: (1) "Markets without divisible and transferable property rights are a sheer illusion"; and (2) "There can be no competitive behavior, real or simulated, without dispersed power and responsibility." Learning to appreciate these facts may help point the way toward the type of reform Cheung is now advocating.

The inconsistency of the current reform measures can be removed only by taking the general approach recommended by Cheung. Only by radical institutional change—privatizing state-owned enterprises and breaking the back of state monopolies—can the vested interests in China be demobilized and the framework set for an internally consistent price mechanism that will guide resources to their highest-valued uses without state intervention. To foster this process, Cheung also proposes using the proceeds from privatization "to establish a judicial system based firmly on the principle of equality before the law."

A Constitution of Liberty and Spontaneous Order

Solving the Chinese puzzle of insulating economics from politics requires, in the words of F. A. Hayek (1960), a "constitution of liberty." By allowing greater economic and personal freedom, and safeguarding them by a sound constitutional framework, China can limit the rent seeking and corruption that have undermined social and economic stability. Furthermore, a constitution protecting private property and freedom of contract will establish the institutional basis for the emergence of a spontaneous market order.[7] Unless China's leaders institute effective constitutional constraints on the power and scope of government, the redistributive state will prevail and the benefits of an open-market order will be lost.

A constitution protecting the rights of persons and property, along with a strong judiciary to guard these rights against political oppor-

[7]On the importance of a constitution of liberty for the emergence of a spontaneous market order, see Hayek (1960, 1982).

tunism and special interests, is essential for the maintenance of a free and prosperous society.[8] By increasing the security of persons, property, and contracts, a nation's wealth will immediately increase, even without any corresponding increase in physical resources or technology. In the long run, the greater security of private rights—both economic and personal—will encourage new investment and foster economic growth. This is why Cheung is so insistent on improving the legal and judicial system in China.[9]

China's leaders recognize the need for a sound legal system if economic reform is to succeed. At the Thirteenth National Congress of the Communist Party, Zhao Ziyang (1987, pp. 58–59), for example, called for "strengthening the socialist legal system" as a way to "guarantee against a recurrence of the 'cultural revolution' and for lasting political stability." He also argued that China should "give play to market forces and free competition" (p. 25) and undertake institutional change "to promote the development of a market system" (p. 36). Meanwhile, Deng Xiaoping (1987, pp. 147–48) observed: "The reform of the political structure and the reform of the economic structure are interdependent and should be co-ordinated. Without political reform, economic reform cannot succeed."

The question then becomes, what type of political reform is consistent with China's market-oriented economic reform? Deng's dictum that "In everything we do we proceed from reality" (1987, p. 177) is an insufficient guide for constitutional change. What is necessary is that Deng and his colleagues acquire an understanding of constitutional and economic *theory*, in light of historical evidence, so that their trial-and-error method can be improved upon. The lack of an overall constitutional perspective—and the failure to understand the relation between private property rights protected by law and the emergence of open markets and competitive prices that coordinate economic activity without central direction—hamper economic liberalization in China. Indeed, according to Cheung, there is "an ideological vacuum in China," with "little understanding of how a market system based on private property rights operates."

Although the Hayekian knowledge problem is generally recognized as a fundamental flaw of central planning, the concept of spontaneous order is still foreign to most of China's leaders who were

[8]For a discussion of the significance of stable property rights and a sound legal system for minimizing rent seeking and promoting economic growth, see North (1987).

[9]Cheung (1986, p. 25) has argued: "The Chinese Constitution, rather than establishing a structure of rights for social and economic interaction, merely serves to confuse. If . . . economic progress depends on constitutional law, China's plans for modernisation would undoubtedly be best advanced by a total rewriting of the country's Constitution."

brought up on Marxian economics and the superiority of central planning, without which the economy is thought to be in a state of chaos.[10] Nevertheless, Deng and other leaders have been impressed (and surprised) by the resiliency of the market and the spontaneous emergence of thousands of small-scale enterprises that followed in the wake of the agricultural reforms. According to Deng (1987, p. 189):

> Our greatest success—and it is one we had by no means anticipated—has been the emergence of a large number of enterprises run by villages and townships. They were like a new force that just came into being spontaneously. . . . If the Central Committee made any contribution in this respect, it was only by laying down the correct policy of invigorating the domestic economy. The fact that this policy has had such a favourable result shows that we made a good decision. But this result was not anything that I or any of the other comrades had foreseen; it just came out of the blue.

The lesson is simple: Individual self-interest will promote the nation's wealth, as Adam Smith envisioned, once the appropriate institutions are in place, whether in Hong Kong or the People's Republic. Foremost among these institutions is an economic constitution that safeguards property and maintains a sound monetary and fiscal regime within which rational economic calculation can proceed.

Deng's willingness to experiment with ownership and price reform has been beneficial. Yet, his quest for improving China's standard of living would be advanced more rapidly if he and his colleagues had an understanding of what James Buchanan (1979, pp. 81–82) calls the "most important central principle in economics," namely, "the principle of spontaneous order" (or "the spontaneous coordination which the market achieves"), and if they recognized that this order critically depends on a constitution of liberty. In this sense, then, the problem of economic reform in China is a problem of constitutional economics, that is, a problem of how to change the rules of the game—the effective economic constitution—to increase freedom and wealth.

In thinking about constitutional change, China's leaders can look both to the West and to their own cultural heritage. In the West, they can draw on the work of classical liberals who first conceived of the market as a spontaneous order; they can learn from the work of James Madison concerning the dangers of unlimited democracy and the importance of constitutional constraints on majoritarianism; and they

[10]See Hayek ([1945] 1948) for a discussion of the information and incentive functions of prices and profits in solving society's economic problem—"a problem of the utilization of knowledge which is not given to anyone in its totality" (p. 78).

can benefit from recent developments in public choice theory, property rights theory, constitutional economics, and the new institutional economics. From their own cultural background, they can gain a greater appreciation of the proper role of government, the chaos created by unlimited government, and the importance of individual freedom in fostering responsible action and spontaneous order.

Both Confucius and Lao Tzu taught that the state should be subservient to the individual and that the best state is the one in which the ruler does not interfere with the natural order, which would emerge spontaneously if individuals followed the principle of noninterference. As Wing-Tsit Chan (1969, pp. 136–37) notes:

> In its doctrines on government, on cultivating and preserving life, and on handling things, Taoism is fully the equal of Confucianism. . . . It teaches submission, but strongly opposes oppressive government. The philosophy of the *Lao Tzu* is not for the hermit, but for the sage-ruler, who does not desert the world but rules it with noninterference. Taoism is therefore not a philosophy of withdrawal. Man is to follow Nature but in doing so he is not eliminated; instead, his nature is fulfilled.

The importance of China's cultural background as the basis for guiding modern-day constitutional reform and economic development is further illustrated by the following passages from the *Lao Tzu* or *Tao Te Ching:*

> Govern the state with correctness. . . . Administer the empire by engaging in no activity. . . . The more taboos and prohibitions there are in the world, the poorer the people will be. . . . The more laws and orders are made prominent, the more thieves and robbers there will be. . . . Therefore the sage says: I take no action and the people of themselves are transformed. . . . I engage in no activity and the people of themselves become prosperous.[11]

These ideas reappeared centuries later in the works of Adam Smith and his contemporaries, and in the discussions shaping the U.S. Constitution. It is to this body of thought and to their own cultural heritage that China's leaders can now turn to find a sound basis for their pragmatic reforms. Armed with the logic of constitutional choice and the logic of the price system, China can move forward into the 21st century confident of its place in the world economy. Once the institutional basis is laid for a stable government by law, order will replace chaos and the open market will allow the creative energy of the Chinese people to be released for their own good and that of the world economy. This is Cheung's hope and it is mine as well.

[11]Quoted in Chan (1969, pp. 166–67).

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Establishing a New Order of the Socialist Commodity Economy

Xu Pengfei

Professor Cheung has freely and candidly described and analyzed the situations, controversies, and contingencies of our economic reform. In the old days the rigid economic mechanism had pulled the leg of our productivity. That is why reform is needed. Our ultimate aim is to build socialism with Chinese characteristics, in conformity with which we are to decide what reforms should be carried out and where they should lead to. We need to learn from the experience of other countries, but not necessarily follow their footsteps.

Price Reform and Wage Reform

China's present economic situation is far better than anybody could imagine 10 years ago. Such indexes as the total output value of the entire society, the total industrial and agricultural output value, and national income are shooting up by dazzling percentages. Statistics show that the actual take-home pay of the peasants and the city dwellers, even though we incorporate the inflation rate, is steadily increasing from year to year. All enterprises, with Party guidance separated from management, are rapidly becoming independent commodity producers and operators. It must also be pointed out that although over recent years a "double-track system" combining the mechanisms of a planned economy and a market economy has been initially introduced, this combination has not attained perfection either in terms of theory or practice. The new order of the socialist commodity economy has to evolve from a highly centralized old order that excludes market mechanisms. Therefore, the establishment of a new economic order in China is a painful and relatively long process. At present, China is in the midst of a transitional period during which

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the new and old systems are interwoven with the new replacing the old step by step. In particular, there now exist two systems, two price structures, two social psychologies, and both positive and negative factors typical of the initial period of growth of a commodity economy. The direct results of this kind of coexistence have been dwelled upon by Cheung. China's economic reform is an unprecedented undertaking for which various blueprints can be drafted. But whatever blueprint is drafted must conform to the actual conditions of China. What, then, is the way out for China?

The 10th Plenary Session of the Central Political Bureau of the Communist Party of China held in mid-August pointed out that the crux of the economic reform lies in price and wage reform. Undoubtedly, this is a timely, wise decision based on previous practice and suggestions by economists both at home and abroad. According to this decision, while the prices of several major commodities and the cost of labor are to remain regulated by the state, the prices of the majority of commodities will be decontrolled and subjected to the adjustments of a fluctuating market. Fluctuating prices will then form a system of their own, leading step by step to the goal that "the State adjusts and controls the market which, in turn, leads and guides the enterprises." The immediate objective for the next five years or so is to gradually systemize more reasonable price relations and solve those problems seriously affecting economic expansion and market growth. The overall aim of the wage reform is to ensure no drop in the actual living standards of the majority of working citizens by wage adjustments and hikes plus necessary allowances and, furthermore, to help improve living standards alongside the development of production. Meanwhile, the principle of distribution according to work will be further put into practice, to solve the problem of unfairness in distribution.

The basic direction in which China's economic reform is going is to establish a hitherto unknown new order of the socialist commodity economy. In other words, we aim at a macro-market appropriately guided by state plans. The core issue is prices. Therefore, if we succeed in the price reform, we can achieve a breakthrough that serves to coordinate the relations of the state, the enterprise, and the individual by well-regulated price and market mechanisms. This is a highly complex undertaking; many things remain to be experimented and theoretically crystallized.

Reform in the Ownership of Enterprises

The pivotal task for China's economic reform is to reform the system of management and administration of our enterprises so as to tap vitality and increase the economic effectiveness of production and management. China's economic reform began with a reform of the responsibility system in the rural areas. Reforms in urban areas are much more complicated, bearing upon many fields of economic endeavor such as production, circulation, finance, and taxation. To increase economic effectiveness, it is imperative to introduce a new and well-coordinated market mechanism and price system, that is, to completely decontrol market prices that were kept down when the planned economy held sway. Prices will then fluctuate according to the law of supply and demand, going up more than down of course. This is exactly what we witness today.

The living standards of Chinese consumers will be raised rather than lowered if three conditions hold: (1) The increase in prices of the means of production is absorbed by the enterprises themselves, which seek to improve management; (2) the wage reform is conducted with a view to relative balance among different walks of life; and (3) actual income is increased along with necessary state allowances.

Our current concern is that in the chain of circulation dubious activities of profiteering take place. We are pleased to see the Chinese government has taken due notice of such economic crimes as bribery, embezzlement, and hands-changing speculation and is clamping down on them according to the law. Apart from punitive measures to combat such activities, what is more important is to help the officials and the people to see that everybody's welfare lies in the well-being of the nation, and therefore we need to forge ahead and surmount all obstacles.

Let me repeat, the question of fundamental importance is to improve the economic effectiveness of the enterprises. It is no good dreaming about increased economic effectiveness while relying on the existing enterprise system of operation. Reform of the existing ownership system is of special importance to the large- and medium-sized state-owned enterprises, since they play such a vital role in the national economy.

Practice has proved that management responsibility by contract is a useful approach whereby the internal structure of the enterprise is made to function more effectively. We are trying to deepen, perfect, and develop an all-round management reform centered on management responsibility by contract so as to make all our enterprises independent operators responsible for their own profit or loss. Reform in the ownership and management systems takes a variety of forms. We need to try out various forms and keep perfecting such forms so that we can decide on the best one through comparison; we do not encourage compulsory uniformity in this respect.

I feel obliged to add that the structural reform of large- and medium-sized state-owned enterprises involves very sophisticated system engineering. Whether an enterprise is owned by the state or owned collectively is not subject to change and must not change. But privately owned enterprises can be allowed to exist alongside.

How do we improve the efficiency of the enterprises with the ownership ultimately in the hands of the state? Brought under public notice for the past few years are such means as responsibility by contract, rent and lease arrangements, and shareholding. The key link in enterprise reform is to help activate truly talented and capable persons who are given a free hand in matters concerning management while being held responsible to a reasonable extent economically. To do so, some reform in personnel management is likewise called for.

Legal Guarantee and Promotion of Economic Reform

China's reform process is to be further deepened. Synthesizing the experience of other countries, we realize that China is now confronted with a problem of how to institutionalize (especially by legal means) the experience she has so far accumulated and the patterns of reasonable development. Economic lawmaking is a matter of special cogency in establishing a new order of the commodity economy. "The Law on Joint Venture Using Chinese and Foreign Investment." China's first law to govern international economic activities, took only six months to make in 1979. Since then, over 20 laws of this kind, over 100 acts regarding international economic activities, and over 200 regulations concerning export-import departments have been instituted. The body of these laws, rules, and regulations have vigorously promoted the expansion and growth of economic and technological cooperation between China and other countries. "The Patent Law," which was passed in 1984 and put into effect on April 30, 1985, has stimulated a flood of patent applications that now number over 68,900 in all with 18,000 for the 1985–86 period. "The Bankruptcy Law" has put an end to the practice of using such executive punitive measures as closing up, suspending production, or merging and changing the lines of products. It has ushered in a highly selective mechanism of competition, and given rise to a sense of crises on the part of the managers who would then spare no efforts to improve management and economic effectiveness.

To date, the legislative bodies at the central and local levels have combined to bring forth a large number of laws, rules, and regulations among which are "The Law of Economic Contracts" (1982), "The General Rules of Civil Law" (1987), and "The Enterprise Law of State Ownership" (1988), to name only a few. There are other laws and regulations governing economic conglomeration, taxation, finance, and land control. Such lawmaking is an indispensable part of economic reform, although there remain measures to be taken to substantiate it.