China’s Conversion to a Market Economy
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by
Kyōichi ISHIHARA

INSTITUTE OF DEVELOPING ECONOMIES
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Acknowledgments

This book in large part has developed out of a number of papers which the author has written while working at the Institute of Developing Economies (IDE). Over eight years separates his earliest paper from the most recently published one. The author did not think it was necessary to change his original viewpoints and basic conclusions. However, he had to revise many parts of the papers to deal with the new changes in China's economic policies and to update the data. As a result, the analysis of this book carries through into the latest stage of China's economic reform and open-door policy commencing in the spring of 1992. Readers will easily understand the author's basic points of view if they read the Introduction and Conclusion which were written at the time of publication.

It was at the beginning of the 1970s that the author took up the study of the contemporary Chinese economy. Prior to that his studies had been directed at the theoretical analysis of capitalist economies under Professors Akira Futami, Akira Watanabe, and Hisashi Asano at the Faculty of Economics, Wakyama University. China at that time was following a different road from Western modernization, and the author saw it as a very worthy topic for study. For his master's and doctorate of sociology at Hitotsubashi University, he studied Chinese society and history under the guidance of Professor Tatsuo Masubuchi and Professor Gaku Nakagawa. At the same time he undertook the study of the Chinese economy as a student in seminars jointly held by Professor Kazuo Nonomura and Professor Noboru Miyahara, wherein he approached his study through a comparison of economic systems.

At that time China still displayed many of the aftereffects of the Cultural Revolution, and even the economic realities were decorated with political and
ideological jargon. In the course of his studies, the author reached an impasse trying to reconcile the gap between the theoretical studies and China’s actual situation. During those difficult days he had the good fortune of coming across Professor Reetitsu Kojima's first-hand studies which provided a great deal of valuable data. These affected his work deeply, and opened his inexperienced eyes. Without Professor Kojima’s strict but warm guidance, the author would probably have abandoned his academic life.

The author has learned much from numerous scholars through participation in the research projects. Professors Takekazu Ogura, Shigeru Ishikawa, Kazuo Yamanouchi, Masuo Tomioka, Hideki Kajimura, Jirō Hyōdō, Tatsumi Okabe, Tamio Shimakura, Kōji Kobayashi, Kazuko Mōri, Yoshiaki Nishimura, Katsuji Nakagane, Tomoyuki Kojima, and Takashi Mitani gave him opportunities to develop his studies further. The author has also been helped by many seniors and colleagues at the IDE. In particular the advice from the late Etsuzō Onoye, the director of the Area Studies Department at the time the author entered the IDE, will never be forgotten. The discussions he had with the other members of two IDE research projects, “The Multilevel Structure of the Chinese Economy” and “The Chinese Economy in the 1990s,” were very stimulating.

This book also owes much to exchanges with many researchers, officers, and other persons in Mainland China, Taiwan, and Hong Kong. Through the generous support of Professor Edward K.Y. Chen at the Centre of Asian Studies, University of Hong Kong, and Professor Joyce K. Kallgren at the Institute of East Asian Studies, University of California, Berkeley, the author has been provided the opportunity to study in Hong Kong and the United States from 1992 to 1994.

In the course of preparing this book for publication, the author received valuable comments from Mr. Nobuo Maruyama, Mr. Kazuo Miyaji, and Ms. Akiko Akemine of the IDE. Dr. William L. Swan kindly took the trouble of not only translating Chapters 1 and 4 into English but also checking my manuscript.

The author was in Hong Kong from the spring of 1992, and he found it more difficult than expected to publish a book while at the same time organize another research project. Mr. Yukio Saito at the English Editorial Division of the IDE maintained a close check on this work and encouraged the author who being overseas was apt to lay it aside. Without his kind and patient help, this work would never have reached final publication.

Lastly the author would like to express his sincere thanks to all of the above persons.

At the Centre of Asian Studies, University of Hong Kong January 22, 1993, the eve of the Spring Festival

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**Introduction:** The Difficulties of Transition from a Planned to a Market Economy

**Commonalities with the Former Soviet Union and Other Eastern European Socialist Countries**

The socialist regimes based on one-party dictatorship in the Soviet Union and other Eastern European countries collapsed in rapid succession during a very brief period of time. The democratization and consequent overthrow of the traditional socialist regimes now seems to be a powerful tide that no one can stop. Certainly China cannot remain insulated from this historic tide. China’s system of one-party dictatorship and central control of the economy suffers from the same difficulties as were faced earlier by the former Soviet Union and Eastern European countries. The common difficulties faced by all of these countries can be set down in the following five points.

First, privilege and corruption, characteristic of one-party dictatorship, have become widespread among party cadres and bureaucrats. The situation has remained unchanged through both the pre-reform and reform periods. In China the market prices introduced by price reform are twice or even three times higher, depending on the items, than the official prices. Exploiting these differentials, paper companies set up by government officials have been earning extortionate profits.

Second, as has been pointed out over the years, the centrally controlled economy is plagued by chronic defects, and the economic weight of central control has been systematically declining. As production increases with the development of the economy, the central government’s information-processing capacity has lagged behind the requirements of expanding economic output.

Under the priority production system with its emphasis on the preferential
development of heavy industries, the classic central economic control based on directives issued by the central government used to function more or less positively. But as the world entered into a period of high-tech development in the second half of the 1970s, Chinese products failed to keep technologically abreast with Western products due to the lack of competition which characterizes this type of socialist system. Television sets, cameras, and other consumer durables made in the West are all more compact, higher in quality, and more durable than their counterparts produced in socialist countries, which are all large, heavy, and clumsy.

Third, China has experienced the same contradictions as the Soviet Union and the Eastern European socialist countries experienced in their transition from a planned economy to a market economy. The Soviet Union and Eastern Europe started reforms in the 1960s, and China turned to an economic reform policy between the end of the 1970s. Accelerated inflation and income gaps among the rich and the poor are some of the contradictions which have generated discontent among the masses. In the Soviet coal mines, strikes broke out frequently demanding a sufficient supply of soap, towels, and other daily necessities. To placate the disgruntled masses, the government had to accept wage increases and pay price subsidies. This in turn increased fiscal deficits which accelerated further inflation. A vicious circle thus set in.

Progressive inflation and general decline in national economic power weakened the country's currency. The official exchange rate became only nominal as the black-market rate became prevalent and effective. A people having no confidence in their country's currency can hardly have respect for the regime.

Fourth, due to the development of the communications industry, it is no longer possible for socialist countries to remain closed to information from the West. In the former Czechoslovakia people were watching TV programs broadcast from West Germany. The Chinese can obtain Western information through the radio. As the open-economy program has progressed, visiting overseas Chinese, students who had studied abroad, and visiting tourists have brought information about the West to the people of Mainland China.

Today a Chinese who has worked in Japan as a migrant worker for a few years can bring home two million yen or so with which he can even build a large residence in his native town or village. Knowing this, more and more Chinese are frustrated by the present regime which restricts freedom of travel abroad. Many are attracted to Western standards of living. The spectacular development of the Asian NIEs also causes particular feelings of envy among the Chinese as China and these countries started from about the same standards of living at the end of World War II.

Fifth, the socialist regime lacks the shock absorbers which exist in the West that serve to mitigate conflicts between the people and the powers that be. Western countries not only have democratic institutions such as free elections, but they also have other facilities which absorb or dissipate public discontent.

Even in Western countries, not all are satisfied with their current life. Rather, many suffer terribly from stress and tensions arising from the serious competition of capitalism. In Japan working people have to do long overtime and then go home in extremely crowded commuter trains. Their life is very exhausting. But they can have a drink at a cheap tavern and sing at a karaoke bar on their way home, or relax a little bit watching a baseball game or a TV show after going home. Or they can play golf or tennis on Sundays. Thus, their discontent with the regime is effectively vented. If they go in for gambling, such as mahjong, pinball games, bicycle races, or horse races, nothing is more important than winning or losing, and they have no energy left for political activities.

Specific Characteristics of Chinese Socialism

As well as having traits that are common with the former Soviet and Eastern European socialism, Chinese socialism also has its own characteristics which are important to note, and we should not discuss the future of the Chinese political and economic systems without reference to these specific characteristics. These can be set forth in the following six points.

First, the Chinese level of economic development is still lower than that of the former Soviet Union and Eastern European countries. The rural population accounts for 80 per cent of the total population and is still based substantially on a non-commodity economy.

Second, Eastern European socialism was a system imposed by the Soviet Union. The Hungarian uprising in 1956, the Prague Spring of 1968, and the other movements for democracy were all crushed by Soviet tanks. In contrast, the socialist regime in China was established through the Chinese people's own resistance against invasion by the Japanese army and through the civil war between the Nationalists (Kuomintang) and the Communist Party of China. China thus adhered to its own socialist model even during the Sino-Soviet conflict of the 1960s. This being the case, there is no logical reason why China should abandon its socialist regime just because the Soviet Union has done so.

Third, the distribution of Western information in China is not as rapid or as widespread as it was in Eastern Europe. Czechoslovakia and East Germany bordered on West Germany. The citizens of these countries thus were able to watch West German TV news and commercials especially after government control was loosened. The Eastern Europeans as Europeans had similar values and shared the same information as their Western counterparts, and the increase in the number of households owning TV sets undermined government information control.

In contrast, less than 40 per cent of Chinese households have TV sets, and of those most can only receive provincial TV stations. China Central Television programing reaches only a few regions. Western information broadcasts from abroad never reach the vast rural areas of China. Only in Guangdong Province are TV antennas of most households directed toward neighboring Hong
Kong. In some big cities such as Beijing satellite broadcasts of overseas television programs are available since around 1991, but only foreigners and a limited number of people can enjoy them.

Fourth, the Chinese social and cultural conditions are greatly different from those of the former Soviet Union and Eastern European societies. For instance, China still has a social climate where popular discontent easily explodes into violence. In 1987 when an additional personal income tax was introduced, tax officers were attacked by the masses in many places, leaving seven dead, six maimed, and 263 seriously wounded. Violence against primary and junior high school teachers carried out by the families of students is frequent. In 1987 three teachers were killed, 26 disabled, and 13 seriously injured in Henan Province alone.

School education has spread rather widely, but the illiteracy rate is still high. Even now, more than 30 per cent of the population is either totally or partially illiterate.

Fifth, China has a vast territory and a huge population. It is twice the size of Europe excluding the former Soviet Union. During the past ten odd years of reform, 19 million small and medium-sized enterprises have developed in the countryside employing a total of 100 million people. Unlike the state-owned enterprises, these small firms do not necessarily follow the state’s food-safety standards, and many of the small and medium-sized enterprises are the ones that are polluting the rural areas with their waste. As a relatively flat continental country, China’s geography is not suitable for the easy disposal of pollution. Furthermore, during the 1960s the Chinese government adopted a policy of promoting the construction of industrial factories in inland areas. All this indicates that unless the central government uses its strong power to control pollution and food safety, a very dangerous situation could easily arise.

Some Eastern European countries and the former Soviet Union suffered from labor shortages and used migrant workers. Former East Germany and Hungary experienced a decrease in their population. However, China’s population, now standing at 1.2 billion, is 400 million more than the total population of Europe and the former Soviet Union combined. Despite its strict “single-child policy,” the population is increasing by 15 million every year. It is also said that by 2000 roughly 20 million people in urban areas and 180 million people in the countryside, a total of 200 million people, will be latently unemployed. The number is equal in size to the total population of Japan, South and North Korea, Hong Kong, and Taiwan put together. During spring and summer every year, one to two million people flow from rural areas into every large city such as Beijing, Shanghai, and Guangzhou. Were the democracy movement to mobilize such people, the situation could become uncontrollable. While the unification of Germany has caused unemployment problems, it should be remembered that former East Germany had a population of only 17 million people. If China’s industrial reserve army of 200 million were to move to the cities or abroad, the situation could not be controlled and no government, Chinese or otherwise, would be able to deal with it. It is therefore necessary for the Chinese government to retain its policy on birth control even though it has been accused of violating human rights.

Sixth, in the 1980s the former Soviet Union and Eastern Europe were beset by a low or minus growth rate of the economy. On the other hand, China has achieved the very impressive annual growth rate of 10 per cent during more than ten years of economic reform and open economy. Chinese stores now offer a wider selection of foods and consumer durables than before. The important difference between Russia and China is that China has 4 million Chinese and 20 million foreign citizens of Chinese origin living abroad. Many overseas Chinese have stepped in to invest their money in China. In particular this has pushed the development of the South China Economies which has come about mainly because of the economic cooperation the mainland has received from Hong Kong and Taiwan. Thanks to its reform and open-door economic policy, China has managed to accelerate its economic development and to raise the people’s standard of living.

Democracy as it is occurring in the former Soviet Union and Eastern Europe represents a historical necessity. Democracy as an institutional framework is superior to dictatorship. However, the existing democratic systems in Western countries do not necessarily function according to the ideal. Whether or not the instantaneous application of democracy and liberty is desirable for China is much more difficult to determine at this stage. Given the existing circumstances in China the only feasible way forward would be to carry out a gradual reform, conducted through measures designed to minimize the contradictions and conflicts that inevitably attend the transitional period China is experiencing.

Composition of This Book

The Chinese economy is undergoing structural changes in the following three directions.

First, in the process of modernization, rapid changes have occurred in the Chinese economic structure which are occurring in many developing countries. The agricultural reforms promoted by Deng Xiaoping since the late 1970s have sent the waves of the commodity economy rippling into the rural areas.

Also changing is the Chinese industrial structure, with economic emphasis shifting from primary to secondary, and then to tertiary industry. Simultaneously, population movement from rural to urban areas has been accelerated.

Second, changes similar to what happened in Eastern Europe and the Soviet Union have occurred in China. As in the first two there is a transition from a centrally controlled economy to a market economy. Bureaucrat brokers have been rampant in pursuing their interests exploiting the differentials between the official and market prices. But if prices are fully liberalized, inflation will gallop. China thus has come to have a multi-layered economic structure where the
state sector based on the principles of planning, foreign ventures and rural small enterprises following market principles, and the traditional rural sector exist side by side, increasing the conflicts and contradictions among them.

Third, China is shifting from a closed to an open economy. China abandoned its closed policy and opted for an open economy by establishing special economic zones and economic technology development zones and by enacting joint venture laws to induce foreign investment. The outcome has been the concentration of human, material, and financial resources in coastal areas and away from inland areas. The economic gap between the two has thus been widened further.

Of the three dimensions where changes are taking place in China, this book focuses mainly on the second, namely, the shift from a planned to a market economy.

Chapter 1 empirically traces how the economic ideal and the real administrative and centrally managed economic system began to diverge during the pre-reform 1970s. It identifies the necessity of economic reform and the orientation of this reform since it was launched toward the end of the decade.

Chapter 2 examines the relationships between the plan and the market in China by differentiating “materials” and “commodities” and clarifying the characteristics of the respective methods of management.

The launching of economic reform brought to the surface the inflationary pressure that had been latent over the years and Chapter 3 will elucidate the mixed inflationary factors (demand-pull, cost-push, and money supply) that have simultaneously been at work to produce the recent inflationary tendency.

Chapter 4 traces the course of economic reform and open-economy policy since the late 1970s. The behavior of state-owned enterprises has been distorted by the failure of the original market-oriented reform because of galloping inflation, while a decentralization-oriented reform has continued to proceed. It will not be easy for Chinese economic reform to get out of the current impasse, but we shall discuss what economic model China is aiming at in the future.

The Framework and Real State of Economic Management Systems during the Pre-reform Period

Introduction

Before 1978 China's institutional framework was oriented toward centralized economic management. This management had all the typical characteristics of the centralized model such as the concentration of decision-making power in the hands of the central bodies, hierarchical planning mechanisms, transfer of decisions in the form of “directives,” economic accounting and planning by physical units, and passive roles of money in the state sector. Though decentralized systems were tried for brief periods, notably by the Great Leap Forward, on the whole China followed the centralized and administrative system of economic management. It is generally argued by most scholars that within this institutional framework central control was effectively exercised in the allocation of resources such as funds, products, and labor force.

While I basically agree with this standard view, I also seek to show in this chapter that gradual changes had already begun to occur in the system by the early 1970s.

In this chapter I will examine the pre-reform systems from the three aspects of planning management, finance, and labor. Under the traditional planning system, production, circulation, and the distribution of goods were administratively controlled. Financial and labor systems supported this administratively controlled system through the supply and distribution of funds and labor force. By analyzing of the contradictions between the framework and the reality of the pre-reform systems, I can explain the necessity and direction of economic reform launched at the end of 1970s.
Planning Management System

Central and Local Planning Management

Chinese economic planning was conducted through two channels of control. The first, as shown in Figure 1-1, consisted of the vertical lines of control by central ministries (tiaotiao) and the other of the horizontal lines of control by localities (kaikai). The changes in the planning management systems during the pre-reform period are characterized as "liangshang liangxia," or "liangshou liangjiao," both meaning "centralization twice and decentralization twice.""

(1) The first round of centralization, 1954

With the founding of the People’s Republic of China, the entire territory of China was divided into six large administrative regions, namely, Northeast, North, Northwest, East, Middle South, and Southwest China. In each region a military government council was set up which controlled the administrative, military, and economic affairs of the provinces and municipalities in the region. In 1954 China abolished the large administrative regions and shifted to the system under which the provinces and municipalities were directly controlled by the central government. The centralization of political and economic power aimed at promoting the rational utilization of resources on a national scale. This change was the first round of centralization.

With this, the number of items categorized as “materials and equipment under centrally unified distribution” (producer and capital goods) [hereafter referred to as “producer goods”) distributed by the State Bureau of Materials and Equipment and other central industrial ministries, comprising those goods classified as “yi lei wuzi” (materials and equipment under category I) and “er lei wuzi” (materials and equipment under category II) which will be explained later increased from 220 in 1953 to 530 in 1957. During the same period, the number of large enterprises directly controlled by the central government also grew from 2,800 to 9,300. The output of enterprises directly controlled by industrial ministries under the State Council came to account for half of the aggregate industrial output.

The central government also came to control 90 per cent of the capital construction investment, leaving only 10 per cent to the discretion of local governments. During the First Five-Year Plan (1953-57), China had 156 major construction projects and 649 other large and medium sized projects. Of these, five major projects and 16 large and medium projects were located in Sichuan Province. All of the investment in those projects was funneled through the hands of central government. The provincial government of Sichuan was allowed to manage only the remainder of the investment relating to agriculture, irrigation, urban public works, education and public health programs. The portion of local investment accounted for only 20 per cent of the total investment put into

Fig. 1-1. Two Planning Management Systems

the province. Even in this case the central ministries defined the items of these local construction projects, and the construction funds also had to be allocated through the hands of the central Ministry of Finance. Besides, distribution of construction materials for such projects was also centrally controlled, and their design and implementation were subject to directives from the central government.5

(2) The first round of decentralization, 1958

Reform in 1958 transferred administrative authority for more than 8,000 enterprises, or 87 per cent of enterprises directly under the central ministries, to local governments (Table I-1). Decentralization also took place from provinces to counties and cities under provincial authorities.

In the area of finances, the provincial, municipal, and autonomous governments no longer turned over the year-end budget surpluses to the Ministry of Finance but retained them for themselves. The number of centrally controlled producer goods was also slashed from 530 to 130 (though later the figure returned to 280 after allegations that rough and ready methods were used in cutting them). Likewise the authority to recruit and hire temporary workers was also transferred from the central government to the provinces and cities.

During the reform period, a double-track system (shuangguizhi) was introduced as a new planning management system. Under the new system, the government of each province, municipality, or autonomous region was required to organize an economic plan within its jurisdiction, covering both centrally and locally controlled enterprises, and present it to the state planning agencies and ministries. Conversely, the draft plans for enterprises which were directly controlled by ministries were to be forwarded to provincial people’s government councils of the areas where such enterprises were located. They were also to be sent to the central ministries in charge of the enterprises concerned. In contrast to this system, the preceding system was called the single track system (danguizhi) under which the provinces, municipalities, and autonomous regions were allowed to draw up plans for only the enterprises they controlled directly. They had no authority to intervene in centrally controlled industrial enterprises within their jurisdictions.

With the reform the authority of local governments over planning was increased. On condition that the centrally planned goals (first book) be achieved, local governments were authorized to set higher industrial and agricultural production goals at their discretion (second book).

The power of enterprises was also increased. Enterprises were now permitted to retain a certain percentage of profits earned. In exchange, the enterprises had to cover their own “expenditures on four items” (costs for technological organization, costs for trial manufacture of new products, costs for labor safety and protection, and costs for the purchase of small fixed assets) as well as their bonus fund (a fixed percentage of total wages). Also the circulating funds

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Enterprises</th>
<th>Total Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>1953</td>
<td>2,800 (1)</td>
<td></td>
</tr>
<tr>
<td>1957</td>
<td>9,300 (1)</td>
<td>58,000 (1)</td>
</tr>
<tr>
<td>1958</td>
<td>1,200 (3)</td>
<td>49,600 (7)</td>
</tr>
<tr>
<td>1965</td>
<td>10,533 (3)</td>
<td>45,900 (7)</td>
</tr>
<tr>
<td>1970</td>
<td>142 (4)</td>
<td>57,400 (7)</td>
</tr>
<tr>
<td>1976</td>
<td>1,300b</td>
<td>78,300 (7)</td>
</tr>
<tr>
<td>1983</td>
<td>2,500 (6)</td>
<td>87,100 (7)</td>
</tr>
</tbody>
</table>

The enterprises needed were now provided as interest-paying bank loans and were no longer allocated grants from the state treasury.

(3) The second round of decentralization, the early 1960s

During the three years of economic difficulties (1959—61), a recentralization process got under way (with the recentralization of the earlier decentralized authority over personnel, finance, industry, and commerce). In 1963 the central industrial ministries brought back under their control most of the enterprises whose management had been earlier transferred to local governments. Thus, more than 10,000 enterprises again became directly subject to the central industrial ministries. The number of centrally allocated producer goods recovered to the 1957 level. The single track planning and management system was restored. Now the industrial ministries under the State Council largely compiled the plans for the enterprises and institutions directly under their authority in their respective areas while the local governments primarily compiled the plans for the local enterprises and institutions under their control.

From the second half of 1964 through the first half of 1966, “trusts” were
tested out as new specialized industrial organizations. Central ministries experimented with nine national trusts and three local trusts, and provinces and municipalities ran eleven experimental trusts, a total of twenty-three. The “trusts” were intended to overcome the partition of management demarcated by local administrative jurisdictions. The “trust” system was also clearly differentiated from the traditional system of industrial management through the lines of the ministries, departments, and bureaus in the following three ways: (a) A unified leadership ahead of the trust replaced the multiple leadership exercised by different levels of local government and different ministries; (b) Factories and mines belonging to a single trust were managed under a single plan instead of each of the factories and mines treated as an independent accounting unit; (c) economic management of the trust replaced administrative management through the lines of the ministries, departments, and bureaus.

The trusts however were too short-lived to have a substantial effect on the Chinese economy. But it is doubtful if they could have functioned as expected even if they had lasted longer. This can be inferred by analogy from the fact that when departments and bureaus were reorganized into corporations (gongsī) toward the end of the 1970s, nothing in fact changed except the names of the organizations.

(4) The second round of decentralization, 1970

During the Cultural Revolution, criticisms were voiced against the early 1960s regulations and systems, such as the regulations for work in state-owned industrial enterprises, (alias the industrial seventy articles—“gongye 70 tiào”), the national and local trust system, and the practice of controlling enterprises along the lines of central ministries and departments. Thus, during the second round decentralization reform in the 1970s, almost all enterprises directly under the central ministries were transferred to the control of local governments. Only 142 enterprises remained centrally controlled (Table 1-1). Even large enterprises of national importance, such as the Anshan Iron and Steel Mill, Daqing Oil Field, and Changchun No.1 Automobile Plant, were all transferred to provincial governments. Some of these enterprises were further transferred from provincial to city or county levels. In 1972 the number of centrally controlled producer goods decreased to 39 per cent of the 1966 level.

The institutional changes throughout the four periods revolved around the issue of the distribution of power between the central and local governments. As the centralized system showed its contradictions in the area of management and control, voices would be raised calling for decentralization of power to local governments. Once power had been decentralized, then planning and management systems found themselves in disarray, aggravating national economic disequilibrium. This would inevitably bring about a return to the centralized system. As Sun Yefang rightly pointed out as far back as the 1960s, the phenomenon of “yishou jiusi, yifan jiuluan” (once concentrated, stiffened; once mitigated, confused) would repeat itself.
governments at different levels causing the whole planning apparatus to become multi-layered. At each level the plan targets were inflated through the use of the "second book," and this undermined balanced development of the national economy. Local governments independently carried out even capital construction, resulting in rapid increase in the number of employed workers and staff and undue expansion of the sizes of capital construction projects.

Third, ideological factors were at work. In urban areas, a large number of industrial and commercial collective-owned enterprises were promoted to the status of state-owned enterprises, causing the number of state employees to expand drastically. In the countryside the slogan “yida ergong” (larger size and a higher degree of public ownership) was implemented, encouraging the merger of people’s communes, production brigades, and production teams. Financially the campaign criticizing “bourgeois rights” had the effect of practically lifting all restrictions on bank loan extension for circulating funds. Furthermore, the People’s Bank of China entrusted local branches with businesses related to deposits and loans, and this generated a situation in which local branches would provide loans to the local governments and enterprises with little restriction on size and conditions. Finally in 1960 the central government had to compensate for bad loans worth 10 billion yuan incurred by the central bank and its branches.

Time was too short for the decentralization during the Great Leap Forward period to crystallize into a stable institution. It gave way in the early 1960s to another round of centralization. This was not only because of the said disequilibrium and confusion in the national economy but also because of the serious natural disasters that ravaged the country for three consecutive years along with the stoppage of aid from the Soviet Union.

Centralization set in again during the 1960-63 period, bringing the planning management system back to its pre-1957 configuration. In some areas, control was even more centralized than before 1957. In 1963, the number of industrial enterprises directly controlled by the central government exceeded 10,000. Local governments were barred from participation in planning management of these centrally controlled enterprises. Even planning for local government-controlled enterprises was made subject to the central ministries. Enterprises were no longer allowed to retain profits while the central government took back its responsibility for the payment of “expenditures on four items” and for bonus funds. Circulating funds again began to be provided directly from public finances, not though bank loans. The number of producer goods controlled by the central government again increased from 280 to 600. Producer goods output beyond the production targets no longer could be distributed at local government discretion. With steel as the single exception, such surpluses over targets were to be disposed of exclusively by the central government.

But the centralized system in China, already at the end of the First Five-Year Plan, was showing a variety of defects and difficulties, and this round of centralization could hardly be free from the same problems. For this reason decentralization measures had to be reintroduced as early as the mid 1960s.

In 1964 control over capital construction investment in agriculture, dairy farming, farm land development, forestry, irrigation and fourteen other areas, with the exception of industry, were shifted from the central ministries to local governments. As a result, when organizing the annual national plan, the central government would leave a certain portion of the national budget to local government use without specifying the industrial sectors or the items. This portion of the budget amounted to 20 per cent or more of the national capital construction budget.

The year 1964 was also the time when the “sanxian jianshe” policy (construction for remote regions away from the coastal areas) was promulgated. For reasons of national defense, Mao Zedong issued instructions for heavy and defense industries to be built preferentially in inland regions (sanxian diqu) and for major facilities in coastal areas and large cities (yixian diqu) to be moved into inland regions. During the five years beginning in 1966, 57.2 per cent of capital construction investment went into inland regions, compared with the 36.9 per cent average for the 1958-62 period. The focus of this policy was Southwest China where five new trunk railway lines were constructed including the Chengdu-Kunming and the Xiangyang-Chongqing lines.

The power and role of local governments were strengthened in the sanxian regions. In Southwest China, for instance, the actual construction program of “sanxian projects” was carried out by a “sanxian construction committee” set up by the central government in the region although the selection of projects and decision on investment plans were in the hands of the central government. The sanxian committee consisted of representatives from the three provincial governments involved as well as the ministries and committees of the central government. The construction work on the sites was subject to the management team under the leadership of the party committee. This was a collective leadership consisting of the delegates from the construction, design, and engineering units, the local party committee, and other related departments. It is said that materials and equipment for such projects were supplied beyond the vertical lines of division between the central ministries as well as the barriers of local jurisdictions. The degree of decentralization then was apparently greater than during the First Five-Year Plan as it now involved even the heavy and defense industries. Apart from whether or not this system was efficient from the point of view of the national economy, the greater power given to local governments proved effective in shorting the construction periods and in other ways.

In 1966 the products of “wuxiao qiye,” or five kinds of small industrial enterprises (iron and steel, cement, chemical fertilizer, agricultural machinery, and coal mining), which had been growing as rural industries, were also distributed based on local government plans.
In 1967 local governments and enterprises were allowed to retain the whole amount of the basic depreciation fund for local enterprises, and in exchange, the central subsidies for "expenditures on four items" were cut. These expenditures were now to be met through the basic depreciation fund.

In 1970, as was already mentioned, most of the centrally controlled enterprises were shifted to local governments. Accordingly, such enterprises and local governments were empowered to retain regular depreciation funds. At the same time capital construction investment came to be shared at a ratio of 4:3:3 (4 for the central government ministries, 3 for local governments, and 3 decided upon through consultation between the central and local governments). Also control over the allocation of producer goods and finances were decentralized to local governments.

The repeated reforms which zigzagged between centralization and decentralization, however, represented mere shifts of power back and forth within the government structure. At no time did the reform overstep the boundary of administrative control. Kornai János argued on the basis of his experience in Hungary that even if regional decentralization was carried out, it was possible to preserve the shortcomings and inefficiencies of the excessively centralized "type IA" mechanism. This is precisely why the post-1978 reform in China had to be oriented toward neither centralization nor decentralization to local governments but toward the expansion of enterprise authority.

Even so, the fact that efforts for decentralization were repeated demonstrated that centralized control had already become dysfunctional and unfeasible in China. Leaving aside the efforts of the Great Leap Forward period, we can identify a series of decentralization efforts launched in 1964 which preceded the full-scale decentralization measures taken in the 1970s. The 1970 reform thus should not be attributed merely to the Cultural Revolution ideology. It was a reaction to the stagnant state of centralization, and it integrated the various decentralization measures that had been carried out in stages during the earlier period.

**Entangled Planning Management Lines**

From 1970 through 1976 more than 2,600 selected enterprises and institutes under the direct control of the central ministries were shifted to local authorities. They included large key enterprises whose purchase of materials and equipment and whose production and sale of products were integrated with national planning. Having had experience only in local planning within their own jurisdictions, local governments found it extremely difficult to plan raw material and machinery purchases and product sales for these major enterprises. Because of this difficulty, the central ministries offered to prepare and manage production plans for these enterprises on behalf of local governments. The central ministries also took direct responsibility for setting the targets on the supply of raw materials and machines for these enterprises. Capital construction plans similarly had to be worked out through consultation between the central ministries and local governments. On the other hand, local governments were in charge of investment in these enterprises as well as taxes and profits turned over by them. This mechanism contradicted itself, and so by 1976 more than 1,300 major enterprises whose management had been transferred to local governments were again shifted to the central ministries which managed them on behalf of the local governments.

In North China and Jiangsu Province, experimented measures were tried which gave local governments the power to allocate and supply major producer goods ("measures for intra-region balance and adjustment of shortages and excesses"). Selected to try these measures were 400-odd enterprises whose management had been shifted in 1972 from the central ministries to local governments. Despite this shift, the production plans of most of these enterprises were managed by the central ministries since most of them were producing for national-level demand. However, in making production plans for these enterprises, the central ministries discovered that they did not know the amounts of producer goods the local governments were allocating to the enterprises. Conversely, the local governments, in allocating producer goods, did not know the production targets that the central ministries had given the enterprises. There was no correlation between the required output volume and the required amounts of raw materials.

These major enterprises needed a large variety of high-quality producer goods in large volumes. Each of them had dealings with a large number of the other enterprises. This being the case, the local governments found it impossible to fully control the enterprises decentralized to them. The central ministries therefore had to take over their management. Thus the "directly supplied enterprises," or zhijie gongyi qiye (enterprises following production plans set directly by the central ministries and supplied with producer goods by the State Bureau of Materials and Equipment), soon came to total 2,000 nationwide. Because of this state of affairs, the central ministries in 1976 began to allocate and supply producer goods to those enterprises which had earlier been placed under the control of local governments.

It was not only the large key enterprises that got entangled in the two lines of overlapping and contradictory planning management between the central and local governments. In 1965, before the Cultural Revolution, as many as 10,533 enterprises were directly subject to the central ministries, and their aggregate output accounted for 46.9 per cent of the total output by the state-owned enterprises. The corresponding figures in 1970 plummeted to 500 enterprises and institutions (142 factories among them) producing a meager 8 per cent output. Between these two dates, management of 10,000 enterprises was shifted to local governments. The entangled control by the central ministries and local governments was a problem for these enterprises too.

Sichuan Province in 1970 saw sixty-five enterprises shifted to its jurisdiction
CONTROL OVER PRODUCER-GOODS DISTRIBUTION REMARKABLY DIMINISHED, MAKING IT INCAPABLE OF MANAGING THE ENTERPRISES TURNED OVER TO THEM BY THE CENTRAL MINISTRIES, AS TABLE 1-2 INDICATES, THE LINES OF MANAGEMENT BY THE CENTRAL MINISTRIES AND LOCAL GOVERNMENT CRISSCROSSED FOR THESE ENTERPRISES. THE CENTRAL MINISTRIES MAINLY CONTROLLED PRODUCTION PLANS, PRODUCER-GOODS SUPPLY, AND CAPITAL CONSTRUCTION PLANS WHILE THE LOCAL GOVERNMENT HAD STRONG POWERS OVER LABOR, WAGES, AND FINANCES.

In the four subsequent years through 1973, 106 more enterprises were turned over from central ministries to Sichuan Province and 246 others from the province to prefectures, cities, and autonomous prefectures. These enterprises, too, suffered from the same problem of entangled lines of control. Capital construction items were also basically transferred to the control of local governments. However, they were divided into complex categories such as items (materials and equipment) directly supplied by central ministries, those controlled by central ministries on behalf of local governments, those under unitary local government control, those invested using local government funds, and imported plants and equipment that required central construction plans while the local government had strong powers over labor, wages, and finances.

The effort to decentralize thus ended in failure as local governments proved incapable of managing the enterprises turned over to them by the central ministries. The failure was particularly noticeable in the case of large enterprises with nationwide interests. But returning to centralized systems was not the answer as decentralization came precisely because of the failure of centralization. Moreover, as will be explained in detail in Chapter 2, the degree of centralized control over producer-goods distribution remarkably diminished, making it difficult to fully restore centralized planning. Also the central ministries could not effectively function unless local governments collaborated with them in the employment of new workers and ensuring the livelihood and welfare of local employees. Both the centralized and decentralized systems proved dysfunctional within the framework of direct and administrative control over enterprises.

FISCAL SYSTEMS

CENTRAL AND LOCAL FINANCES

The state budget of China is divided into central and local finances. The latter are composed of the provincial, municipal, and autonomous-region budgets and the county, municipal, and autonomous prefecture budgets. As shown in Figure 1-2, the local total budget includes not only that for its own level but the budgets for the lower levels as well. For example, the financial bureau of a province compiles the province total budget by integrating the budget for the provincial level with the county total budgets presented by the subordinate counties. (The township (xiang)-level budget has not yet been integrated with the local budget.)

The natural way to determine whether central or local budgets predominate would be to compare the size of revenues and expenditures. But in China the concepts of revenue and expenditure are not clearly defined. Official statistics dealing with local finances are not compiled using the same concepts. Therefore we must begin by first clarifying the concepts of revenue and expenditure.

Fiscal revenue used in the Chinese discourse of local finances has three conceptual meanings. We will explain these using the example of Liaoning Province, shown in Figure 1-3.

The revenue of local finances in the first sense of the word is collected or otherwise obtained according to the local government's budget plan. This revenue mainly consists of profits turned over to the local government by enterprises under its control and from various taxes it collects. This may be called "revenue retained within the budget."

The whole amount of "revenue retained within the budget," however, does not go towards Liaoning Province's fiscal expenditures. Part of it is transferred to the central coffers. The remaining portion is what the province can dispose of for itself. The second concept of fiscal revenue denotes this portion, namely, "revenue used for local finance."

The third concept of fiscal revenue refers to "revenue gained locally." This includes all of the profits turned over by enterprises and taxes collected in the province, irrespective of whether they finally accrue to the local government or to the central government. This therefore comprises: (1) the revenue used for local finances, (2) the portion of revenue that will be turned over to the central finances, and (3) revenue of the centrally managed enterprises plus taxes directly collected by the central government.

**TABLE 1-2**

<table>
<thead>
<tr>
<th>Central Ministries</th>
<th>Cities</th>
<th>Provinces</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government offices as competent authorities</td>
<td>9</td>
<td>49</td>
</tr>
<tr>
<td>Labor and wages</td>
<td>0</td>
<td>59</td>
</tr>
<tr>
<td>Finances</td>
<td>14</td>
<td>51</td>
</tr>
<tr>
<td>Supply of materials and equipment</td>
<td>5</td>
<td>23</td>
</tr>
<tr>
<td>Production planning</td>
<td>0</td>
<td>14</td>
</tr>
<tr>
<td>Capital construction planning</td>
<td>50</td>
<td>9</td>
</tr>
</tbody>
</table>

Table 1-3 shows changes over time in local revenue and expenditure taking into account the said differentiated concepts.

A comparison of the ratios of local revenue retention, $(A)/(B)$, between Tianjin and Shanghai indicates that Shanghai enjoyed overwhelmingly higher rates than Tianjin during the First Five-Year Plan period. This is partly accounted for by the fact that Tianjin had greater “revenue retained within the budget” than Shanghai. But during and after the adjustment period of the 1960s, Shanghai’s “revenue retained within the budget” showed a spectacular growth. In contrast this, revenue for Tianjin did not increase very much. Probably reflecting this, Shanghai’s $(A)/(B)$ ratio remained half or one third that for Tianjin from the 1960s to the 1980s. In other words, Shanghai contributed greatly to the central finances during that period.25

The picture is slightly different if we look into the ratio of local retention to the “revenue gained locally,” or $(A)/(C)$. Since the 1950s, Shanghai has consistently been transferring a large portion of the wealth it generates to the central government. It is true that the ratio of local retention rose in the 1980s but this was not above the previous highs registered in 1975 and 1978.

In Japan local self-governing bodies receive state subsidies equal to 70 per cent of their budgets. As they meet only 30 per cent of their expenditures through their own revenues, Japanese local self-governing bodies are said to be only “30 per cent autonomous.” In China the fiscal revenue directly collected through the central financial ministry is less than through the local governments. However the central financial ministry exercises great power by allocating revenues from rich to poor provinces. With the financial structure, fiscal revenues from the fifteen rich provinces and municipalities are redistributed to the twelve poor provinces and autonomous regions.26 Though there is a clear difference between China and Japan in the ratio of local fiscal revenue to central fiscal revenue, in both countries the central government maintains a firm grip on nationwide fiscal expenditures. Figure 1-4 compares the relationship between central and local finances in the two countries.

Now let us examine the composition of the “revenue retained within the budget” and the actual expenditures of the central and local governments. During the First Five-Year Plan, the central government met 75 per cent of the state fiscal expenditure. Of this 75 per cent, about 40 per cent came from revenue directly collected by the central government and about 5 per cent was fiscal deficit. The remaining 30 per cent was accrued from local government finances.27 The local governments accounted for only a quarter of the state fiscal expenditures even though they were responsible for collecting more than half of the state fiscal revenues.

In 1955–56 the fixed revenue for local finances and the revenue retained to the fixed ratio for local finances together accounted for 60–80 per cent of the provincial and municipal budgets. Though this meant that local governments had large sources of revenue, in practice most of the revenue was categorized.
### TABLE 1-3

<table>
<thead>
<tr>
<th>Year</th>
<th>Local Revenue</th>
<th>Revenue Gained Locally</th>
<th>Semi-Local Revenue</th>
<th>Central Revenue</th>
<th>Relative Share of &quot;Local Revenue Gained Locally&quot; to &quot;Local Revenue&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>172.05</td>
<td>154.69</td>
<td>79.63</td>
<td>7.02</td>
<td>46.15</td>
</tr>
<tr>
<td>1981</td>
<td>179.40</td>
<td>154.69</td>
<td>86.43</td>
<td>8.34</td>
<td>47.93</td>
</tr>
<tr>
<td>1982</td>
<td>187.40</td>
<td>154.69</td>
<td>94.81</td>
<td>9.49</td>
<td>50.81</td>
</tr>
<tr>
<td>1983</td>
<td>195.50</td>
<td>154.69</td>
<td>104.53</td>
<td>10.64</td>
<td>53.93</td>
</tr>
<tr>
<td>1984</td>
<td>203.60</td>
<td>154.69</td>
<td>115.47</td>
<td>11.85</td>
<td>56.90</td>
</tr>
<tr>
<td>1985</td>
<td>211.70</td>
<td>154.69</td>
<td>127.71</td>
<td>13.14</td>
<td>60.91</td>
</tr>
</tbody>
</table>

### Sources and Notes
- Figures in parentheses were calculated: (revenues retained within the budget) - (expenditures used for local finance).
- Total "enterprise revenue" happens to be smaller than expected because compensations for deficits registered by commercial enterprises are subtracted in advance.
- These figures were obtained by subtracting the expenditures used for local finance from the figures for Tianjin from the Tianjin city statistical bureau (Beijing: Zhongguo tongji chubanshe, 1985, pp. 333-36).
- These figures were obtained by subtracting the expenditures used for local finance from the figures for Shanghai from the Shanghai city statistical bureau (Shanghai: Shanghai tongji yijian, 1985, pp. 296-97).
- Local revenues retained within the budget.
as items for central government allocation. Local governments thus had no authority to allocate the greater portion of revenue for themselves.28 This was because during that period more than 80 per cent of the economic construction budget and the total defense budget had to be met by central finances. In contrast, 72 per cent of the social welfare, educational, and cultural expenditures and 80 per cent of the administrative expenditures were met by the local governments.

As with other aspects of the planning management system, the finance management system too underwent decentralization. Typical reforms in this direction were carried out in 1958 and 1970. Considering that the ratio of local government fiscal expenditures was tending to increase, the direction set by these two reforms was necessary. But both reforms were short-lived.

Decentralization failed partly because it kicked off competition over power between central and local finances. In the process of decentralization, central government and local governments are bound to engage in bargaining over which items of revenue and expenditure should belong to which side. The amount of revenue to be handed over to each local government is usually based on the items and sums of revenue and expenditure for the previous year or several years. However, under the traditional system of unitary central control over revenues and expenditures, the total amount of expenditures encompassed by the central finance in the past did not necessarily embody the items to be managed by the central government. Conversely, some of the expenditures actually met by local governments seemed more logically the responsibility of the central government. This being the case, the division of financial power between the central and local governments based solely on past records would often leave jurisdictional responsibilities unclear at both levels.

Conflicts between the central and local power occur in the process of centralization as well. In 1964 “trusts” were organized in 19 industrial sectors, including nine operating at the national level. Where local enterprises were integrated with these national trust, the local governments lost major sources of fiscal revenue. It is said that in a number of places the factories earmarked for integration with national trusts transferred personnel to other factories, moved their machines out, and changed lines of production to other industries to escape integration.31

From 1971–80 the ratio of local governments involved in the collection of state financial revenues grew to 80 per cent. Reflecting this increased role in collecting revenues, the share of local finances in state financial expenditures grew to around 50 per cent.32 Though state finances still weigh heavily in China’s financial structure, since the 1970s there have been increasing signs of improvement for local finances.

The Extra-budgetary Fund

Of the fiscal resources which innately are counted as fiscal revenue, the por-
tion which is incorporated into the central or local government budget is called the “budgetary fund.” This pertains to the state fiscal revenue presented in the government’s annual budget and settlement reports. Of the same resources, there is another portion which is exempted from the central or local government budget and left to local governments, state-owned enterprises, and various competent government offices for appropriation. This latter is called the “extra-budgetary fund.”

The extra-budgetary fund has the following characteristics: First, local governments, enterprises, and other competent government offices involved have control over the respective extra-budgetary funds they themselves have generated. In other words, other bodies which have not generated these funds have no right to appropriate them. Second, the extra-budgetary revenue is purpose-specific. For instance, the additional charge for urban public works can be appropriated only for urban public facilities and public works. Third, the ways of appropriating these funds are varied and not uniform.

The extra-budgetary funds were introduced for the following two reasons: First, there are certain expenditure items which by nature are not congenial to centralized management. These include road maintenance costs, port management costs, and market supervision costs, which should be met flexibly as need arises. In the 1950s the above three expenditures accounted for 90 per cent of the extra-budgetary funds, and even in the 1980s they still represented a 70 per cent share. Second, there was the political need to provide financial incentives to local governments as well as state-owned enterprises. The introduction of the profit retainment system for state-owned enterprises was a typical case of this kind.

The total amount of extra-budgetary funds of various kinds began to soar during the mid 1970s. In 1953 the extra-budgetary fund represented only 4 per cent of budgetary funds. The figure jumped to 59.97 per cent in 1982. Even in 1977, before economic reform was launched, the extra-budgetary fund already made up 35.6 per cent of the year’s budgetary funds. In Shanxi Province the local extra-budget fund amounted to 62 per cent of the provincial total budgetary funds in 1980. In 1982 Jiangsu Province’s extra-budgetary fund almost equaled its budgetary fund.

Extra-budgetary funds basically consist of (1) various additional tax revenues accruing to local finances, (2) road and river maintenance duties and forest managing funds received by administrative offices and institutions, and (3) retained profits and depreciation funds left in the hands of state-owned enterprises and the government agencies in charge of these enterprises.

The shares of the above three categories in the extra-budgetary fund appropriation are shown in Figure 1-5. While the extra-budgetary fund as a whole has been growing rapidly, the portion attributed to the state-owned enterprises including the departments in charge of them has come to form an overwhelming share.

Given the enormous size of the extra-budgetary fund in comparison with the budgetary fund, the former has nowadays been called “dier caizheng” (second finance). This part of finances is increasingly outside of administrative management because a large portion of it is attributed to enterprises. As extra-budgetary funds are autonomously controlled by local governments and enterprises including the departments in charge of the enterprises, cases of the irregular use of such funds in contravention to regulations are frequently reported. For instance, state-owned units will unduly extend the scope of extra-budget revenue to increase their income, or appropriate the fund for purposes other than specified, such as for the construction of office buildings, assembly halls, hotels and guest houses (lou, tang, guan, suo), or use them for capital construction projects not prescribed in the state plan.

The extra-budgetary fund system is in line with the requirements of the current stages of economic reform because it allows flexible responses to needs that cannot be met by administrative management methods and because it gives local governments and enterprises greater discretionary powers. The expansion
of the extra-budgetary fund started even before economic reform was launched. Already in mid 1970 the extra-budgetary fund was equal to 30 per cent of the budgetary fund. These circumstances have compelled the government to modify emphasis of its financial policy from “qualitative control” through fiscal measures to “quantitative control” exercised through banks. The direction of fiscal and financial reform in the 1980s thus reflected the expanding tendency of extra-budgetary funds since the mid-1970s.

Inequalities in the Midst of Policy Egalitarianism

Urban Welfare Turned to Established Privilege

Being registered as an urban resident means accessibility to various conveniences and privileges in addition to receiving a relatively high income. The staff and workers of state-owned enterprises are entitled not only to a basic wage as provided in the wage scale and a job allowance which is practically like a wage, but also to other allowances for house heating in winter, price subsidies for non-staple foods, subsidies for home travel expenses, and livelihood subsidies. A national survey in 1978 revealed that there were more than 200 different kinds of subsidies given to the staff and workers of enterprises. Moreover, state-owned enterprises supply employees and their families with cultural and gymnastic facilities such as cultural palaces, libraries, clubs, ball game gyms, and night schools. They also provide housing, dining halls, nurseries, kindergartens, primary and secondary schools, barber shops, and bath houses. The charges for these facilities are free or extremely low. Expenses for this welfare work borne by enterprises is equal to 80 per cent of the total wage bill they pay their employees.

Under this system of ample benefits and welfare for urban residents, China has managed to keep the wage level low for the sake of a high savings ratio. In other words, the free or low cost provision in kind of houses and other benefits has been needed so that urban workers would not fall into destitution because of low wages. Also, given the generally low standards of living prevailing in China, there has been the real possibility of the emergence of a poverty-stricken population unless the small economic pie was divided equally among the people.

But this egalitarianism limited to urban working people has had a hollow sound to many of the people living outside urban areas who have not enjoyed the same benefits. To them it is nothing more than special privileges set aside for urban residents. Farmers in the countryside have not felt the strong contradiction since they have been working under an entirely different ownership system and living in different geographical locations. But those who work as temporary laborers in urban factories or live with a rural registry in cities and suburbs have felt that the benefits the urban registered people enjoy are privileges they have been unduly excluded from.

Moreover, those who live in urban areas but are excluded from grain rations because of their rural registry are not a negligible number. According to this author’s estimates (Table 1-4), urban residents with rural registries totaled 28,750,000 in 1965, 48,010,000 in 1978, and 58,510,000 in 1981. They consist of (1) farming households either doing farming only or doing sideline jobs in the suburbs of cities, (2) temporary workers and their dependents in cities who have quit agriculture and are not entitled to food rationing, and (3) self-employed persons and their dependents. These people accounted for 22.0 per cent, 27.8 per cent, and 29 per cent of the total urban population in 1965, 1978, and 1981, respectively.

The welfare benefits the urban registered population has enjoyed can be seen as an expression of egalitarianism. But to the workers and farmers with rural registry who have been excluded from these, the same system has been one that ensures special and exclusive privileges for regular urban staff and workers. Nor has egalitarianism ever been thoroughly implemented even among the strata of people who are covered by this welfare system.

There are disparities in welfare benefits between the state-owned sector and the collective sector in the urban areas. The staff and workers in the collective sector represented 12.7 per cent, 24.7 per cent, and 21.6 per cent of the state-owned sector represented 12.7 per cent, 24.7 per cent, and 21.6 per cent of the state-owned sector represented 12.7 per cent, 24.7 per cent, and 21.6 per cent of the state-owned sector represented 12.7 per cent, 24.7 per cent, and 21.6 per cent of the
sector staff and workers in 1958, 1965, and 1978, respectively.

During the Cultural Revolution, a drive was carried out to "raise" collective-owned urban industrial enterprises to state-owned enterprises. For instance, 60 of the 110 collective-owned factories under the Beijing Municipality Second Industrial Bureau were changed to state ownership.

Of the collective-owned enterprises, large ones were categorized as "dajiti," or major collective-owned enterprises. They were controlled by county or city departments in conformity with the management system of state-owned enterprises. The profit distribution and investment of these collective enterprises were directed by the local government departments in charge of them. The government department in charge also intervened not only in the procurement of raw materials and the production and sale of products, but in personnel, funding, and inventory management as well.

While the urban collective-owned enterprises thus were subject to the same regulations and production quotas as state-owned enterprises, they were grossly discriminated against when it came to benefits. The government departments handling allocation of raw materials, equipment, and energy followed the principle of "state-owned enterprises first and collective-owned enterprises later." When material supplies were short, they were preferentially provided to state-owned enterprises.

Where the same kind of commodities were sold in both state and collective commercial shops within the same market area, the latter was expected not to set the retail prices of their products higher than the former official prices.

Among the collective-owned enterprises, small ones are categorized as "xiaojiti" (minor collectives). In urban districts they are also called "jiedao gongchang" (neighborhood factories). Neighborhood factories arose in 1958 out of the efforts of "neighborhood committees" (jiedao jumin weiyuanhu) to organize women and other residents in residential quarters into factories. Later the neighborhood factories began to function as absorbers of unemployed urban youth.

The Ministry of Water Resources and Electric Power regarded neighborhood factories as unproductive and only grudgingly supplied them with power. Moreover they were charged higher power fees than state-owned enterprises.

In employment, too, the collective factories were often burdened with obligations that the state-owned enterprises were exempted from, such as obligatory hiring of unemployed persons, physically disabled persons, and vagrants.

The collective factories also had to conform with the wage table and promotion system of the state-owned enterprises. Moreover, there was even a provision that collective factory wage, welfare, and intra-firm benefit levels were to be lower than those for state-owned enterprises. The collective-owned enterprises were also subdivided into different levels. According to the rules, wages at minor collective were to be lower than those at major collectives. There were also differentials in the amount of grain provided during the Spring Festival to the state-owned enterprises, major collectives, and minor collectives.

Regular Employees and Temporary Workers

As mentioned above, there was a portion of the staff and workers in the urban and state sector that was excluded from welfare and fringe benefits including grain rationing. In order to clarify the actual situation of this inequality, I would like to discuss China's classification of staff and workers.

The state sector has the following four parallel forms of employment:

(1) Regular employment (guding zhigong)

Regular employees are those who are hired by enterprises and other bodies with the official approval of the Ministry of Labor and other administrative agencies and in accordance with the government's labor allocation program. Once hired, such employees can work for the enterprise or body involved until retirement age no matter what their performance, unless they commit a serious misbehavior.

(2) Temporary employment (lingshi zhigong)

Temporary employees are those who are temporarily hired under a contract signed with the employer on the basis of the government's labor allocation program. They can be fired on expiration of the contract. They are mainly engaged in seasonal or temporary production work or services. Prior to the Cultural Revolution, they were called "contract employees" (hetongzhi zhigong). But unlike the new "contract employees" since 1980 (as related below), these contract employees are not covered by unemployment insurance, nor can they enjoy welfare measures and fringe benefits.

(3) Extra-plan employment (jihewai yonggong)

Extra-plan employees are those who are directly recruited and hired by state-owned enterprises beyond the personnel strength allocated to them under the government's labor allocation plan.

(4) Contract employment (hentongzhi zhigong)

This is a new type of employment that emerged as part of the employment system reform in 1980. The new system began to be fully implemented in the fall of 1986. Under this system the enterprise holds examinations for applicants, and those who have passed the exam sign a contract with the employer. These employees are different from the above-mentioned temporary workers in that they are guaranteed the same rights as the regular employees. But they must renew their contract after expiration of the original contract term. When they are fired, they are entitled to unemployment insurance benefits, but the benefits are only 50–70 per cent of their basic wage. They are not treated as well as regular employees in welfare, fringe benefits, and housing. Contract workers include "rotation workers" who are hired for mines, transportation, and railway services (on the basis of contracts concluded between the state-owned enterprises and rural production brigades or villages under which workers serve in rotation so as to avoid the negative influences of injurious and heavy work). Also included in this category are peasants who are hired for construction
projects as contract workers. However, the contract workers hired before the Cultural Revolution and those peasants not hired under the contract employment rules are not counted as contract workers in compliance with this category.

Of the four types of employees, (1) and (4), namely the regular employees and contract employees, are considered to be beneficiaries of social security, welfare, and fringe benefits. Categories (2) and (3), namely temporary employees and extra-plan employees, are excluded from these benefits. The difference between temporary employees and extra-plan employees is that the former are hired with the approval of provincial governments and are integrated with government labor allocation plans while the latter are not counted in government plans. In Japanese categorization, both would belong in the category of temporary workers. Table 1-5 gives a breakdown of state-sector employees into three groups by the form of employment: regular employees, temporary employees (including extra-plan employees), and contract workers of the new type.

The table shows that during the Great Leap Forward and the early 1970s decentralization period, peasants were encouraged to take up urban jobs and temporary workers were promoted to the status of regular employees.

The central government in a decision taken in June 1958 permitted each local government to recruit workers with only the provincial government’s approval and without the need to secure the central government’s approval. This decision expanded the employment of peasants in urban areas.

The number of staff and workers in the state sector increased by 25,932,000 during the three years from 1958. Fifty-five per cent of the 26 million added to urban employment, or 14,300,000, came directly from the rural areas. This number was equal to 72 per cent of the newly hired work force in rural areas during that same period. In the single year of 1958, the urban work force jumped by 20,827,000, including 11,055,000 regular employees and 9,762,000 temporary workers. In the following year, the number of temporary workers in the state sector decreased by 1,884,000 and regular employees grew by 2,169,000. The total work force in the state sector that year did not change significantly. This year clearly indicates that a vast number of temporary employees became regular employees that year.

During the Great Leap Forward, the urban population increased explosively together with urban employment. The urban population increment amounted to a staggering 30 million. The share of the population receiving commodity grain supplies also rose from 15 per cent in 1957 to 20 per cent in 1960. Furthermore the consequent increase in total wages tightened the demand-supply ratio for consumption goods. During the following period of economic adjustment, 20 million state-sector staff and workers were returned to the rural areas. Most of the returnedees were believed to be temporary workers.

As Table 1-5 shows, the staff and workers in the state sector who lived in mining or urban areas increased by 9,830,000 in the two years of 1970–71 (by four million in the county-managed industries). Of these, six million were hired
from the rural areas. This figure was far larger than what the government plan had set. In 1970–71, for instance, the government planned to hire 3,060,000 new recruits altogether, but the actual increment reached 9,830,000. They included 8,861,000 regular employees and 969,000 temporary workers. For this reason both total wages paid and the commodity grain sold turned out to be larger than planned (up 2 per cent and 7.7 per cent respectively from the planned levels in 1971). 47

In 1972 the government slashed employment to the planned level. The groups targeted for cutbacks were temporary employees recruited from the rural areas in 1970, “mingong” hired year-round the year for capital construction (peasants the government mobilized for construction work at low or no wages), and those who had illegally entered cities. With this measure the urban population entitled to commodity grain rations plummeted by five million. In 1973 and 1974, 1,700,000 more returned to the rural areas. 46

While the overwhelming majority of the staff and workers in the state sector are regular employees, temporary workers also play a significant role. The percentage of temporary workers within total state-sector employment peaked in 1959 at 26 per cent. It was 13.9 per cent in 1970.

Temporary workers by and large do not do skilled work and instead engage in dangerous, heavy, and dirty work which regular employees shun. This is why Chinese state-owned enterprises employ a vast number of temporary workers even when they suffer from a surplus of regular employees. 49 A source not covered in Table 1-5 reports that in 1971 there were more than nine million temporary and rotation workers all over the country. If true, the number of temporary workers would be far more than statistically shown. Of the nine million, only 2.5 million were engaged in work of a temporary or seasonal nature. Seventy per cent, or 6.5 million, were doing permanent jobs though they were still called temporary workers. 50

In 1958 “a double-track labor system” was proposed. This was to apply the old system to veteran workers and the new system to newly hired workers. The traditional system thus was to apply to the regular employees who would be retained on the job while temporary workers would be hired and released as the enterprise needed them. This double-track system was also to promote the “labor system for being both worker and peasant” under which temporary workers would be far more than statistically shown. Of the nine million, only 2.5 million were engaged in work of a temporary or seasonal nature. Seventy per cent, or 6.5 million, were doing permanent jobs though they were still called temporary workers. 50

In 1958 “a double-track labor system” was proposed. This was to apply the old system to veteran workers and the new system to newly hired workers. The traditional system thus was to apply to the regular employees who would be retained on the job while temporary workers would be hired and released as the enterprise needed them. This double-track system was also to promote the “labor system for being both worker and peasant” under which temporary workers could go back to their home villages during the busy season for agriculture. This plan was put into practice in a few provinces but fizzled out as the Great Leap Forward drove ahead. 51 As was earlier said, a large number of temporary workers were promoted to regular employees during the Great Leap Forward.

The “labor system for being both worker and peasant” was again tried in 1964. But as the Cultural Revolution began, “the double-track labor system” came under fire. A campaign for the promotion of temporary and subcontract workers to the status of regular employees again gained ground. 52

In conventional studies this “labor system for being both worker and peasant” has been understood as a characteristic aspect of the Chinese socialist model. But it should be remembered that precisely during the Great Leap Forward and the Cultural Revolution, undoubtedly the periods that manifested the Chinese model under Mao Zedong’s leadership, this labor system came under criticism. Though this occurred only in the state sector, it should nevertheless be remembered that during the Great Leap Forward and the Cultural Revolution there was a campaign for changing the status of temporary employees to regular employees.

These moves for the mass employment of peasants in the state sector and for the promotion of temporary workers to regular employee status during the Great Leap Forward and the Cultural Revolution were certainly motivated by egalitarianism. This aimed at allowing peasants and temporary workers to share in the same privileges enjoyed by urban employees. However, this attempt eventually failed because the expanding range of population enjoying urban privileges led to undue increase in wage payments and in the amounts of rationed grain and other consumption goods which in turn caused fiscal deficits.

In the 1970s the number of temporary employees again began to increase as Table 1-5 illustrates. The new contract worker system introduced in 1980 addressed the need for enterprises to have a temporary worker-like labor force. The new system also was intended to undermine the privileges regular employees automatically enjoyed until their retirement in order to remedy the problem of “disguised employment” which state-owned enterprises generally suffered from. During the Great Leap Forward and the Cultural Revolution, efforts were made to overcome the existing inequalities by extending the privileges enjoyed by urban employees to peasants flowing into cities. In contrast, the present economic reform strives to “equalize competitive conditions” (which differs from the equality of actual incomes) for all by reducing the sizes of the privileged strata of working people.

Summary

Under the old system which lasted until 1978, China had the institutional framework wherein the economy was centrally and administratively managed. That system was able to contribute to Chinese economic development. By exercising central control over the distribution of resources such as funds, goods, and labor force, China was able to achieve a high rate of accumulation and thus to industrialize. China had inherited from the past a number of negative factors, such as a low level of income which threatened many people with hunger, enormous population pressure, wide regional disparities, undeveloped transportation and communication, rural autarky economy, and high illiteracy. Burdened with such negative factors, China had to struggle to achieve along for economic construction. The socialist ideology based on Soviet orthodoxy, international isolation
in the 1960s, and the national priorities given to military strategy were other factors that strengthened the centralized and administrative system of economic management.

At the same time, however, the economic realities under this centralized and administrative management system were developing on a collision course with the dominant institutional framework. Centralization soon reached its limits in the area of planning management, and this led to decentralization attempts toward the end of the 1950s and in the early 1970s. But both of these attempts stayed within the framework of administrative control. Both centralization and decentralization within this framework proved dysfunctional.

The system dysfunction became more apparent by the mid 1970s. The importance of centralized control in the allocation of producer goods diminished. In public finance, extra-budgetary funds not incorporated with the state budget began to expand rapidly. In the area of labor and distribution management, the number of temporary workers and extra-plan employees also began increasing rapidly, generating contradictions with the regular employees who were given ample protection under the government's labor control policy. The shift to the new economic reform policy in the late 1970s was prompted by the contradictions between the institutional framework and the economic realities that surfaced during the middle of the decade.

Notes


5 Jin Yan, "Jianchi gaige de zhengque fangxiang" [Adhere to the right direction for reform], in Guomin jingji yu guanli, 1983, No.10, p.91.

6 The policy for trust formation was proposed in August 1964. It was written under Liu Shaoqi's instruction by the leading Party group of the State Economic Commission. The trusts proposed included the Tobacco Corporation and Salt Corporation under the Ministry of Light Industry, the East China Coal Industrial Corporation under the Ministry of Coal Industry, the Automobile Industrial Corporation under the First Ministry of Machine-Building Industry, the Tractor and Diesel Engine Parts Corporation under the Ministry of Agricultural Machinery Industry, the Textile Machinery Corporation under the Ministry of Textile Industry, the Aluminum Industrial Corporation under the Ministry of Metallurgical Industry, the Rubber Industrial Corporation and the Pharmaceutical Industrial Corporation under the Ministry of Chemical Industry, the Geological Machine and Instrument Corporation under the Ministry of Geology, the Beijing, Tianjin, and Tangshan electric corporations under the Ministry of Water Resources and Electric Power, and the Changjiang Shipping Corporation under the Ministry of Communications. Added to this list in April 1965 were the Petroleum Industrial Corporation, Instrument and Apparatus Industrial Corporation, and the Timber Work Corporation. (Fang Weizhong, ed., Zhongguo renmin gongheguo jingji dashibi [The People's Republic of China economic chronicle] (Beijing: Zhongguo-shuhuikekexue-chubanshe, 1984), pp.379—92.


9 Luo, "Woguo jingji," p.89.

10 Zhou, ed., Dangdai Zhongguo, p.76.


17 Kornai János (translated and edited by Tsunao Morita), Ketzaigai kakkō no kanōsei [Possibilities of economic reform], trans. and ed. Tsunao Morita (Tokyo: Iwanami-shoten, 1986), p.27; Kornai classifies socialist models into the following four: IA—direct bureaucratic regulation, IB—indirect bureaucratic regulation, IIA—controlled market regulation, and IIB—liberalized market regulation. Kornai participated in an international symposium on macroeconomic management held on board the Changjiang River sightseeing ship Bashan in September 1985, and pointed out that China after the economic reform was at IB stage and heading for IIA. (Shijie jinji dabaobao, October 10, 1985)
21 Ibid., pp.136–37.
22 Jin, “Jiangxi gaige,” p.94.
23 He and Wang, ed., Zhongguo jihua, p.147.
24 In April 1985, the “Xiang (then) caizheng guanli shixing banfa” [Internal procedures of village and township fiscal management] was promulgated. This provided for a four-level management system, that is, (1) the central level, (2) the provincial, municipal, and autonomous-region level, (3) the city and county level, and (4) the township and town level. (Minoru Nambu, “Zaisi kinyu” [Public finance and banking], in Chugoku soran [Tokyo: Kazankai, 1988], p.349).
25 Cao Guoqing and Weng Jiuan, “Shanghai caizheng tizhi gaige chutan” [Preliminary investigation on Shanghai’s fiscal reform], in Fuyin baokan ziliao—caizheng jinrong [Copied materials of newspapers and magazines—public finance and banking], 1982, No.3, p.31.
26 In the two remaining provinces, the budgets are balanced (Sun Xuewen, “Woguo yinggai shixing ‘daquan jizhong xiaoquan fensan’ de caizheng tizhi moshi” [Our country should practice the economic system called ‘centralizing major powers and decentralizing minor powers’], in Fuyin baokan ziliao—guomin jihua yu guanli [Copied materials of newspapers and magazines—national economic plan and management], 1983, No.9, p.49).
33 Li Fuyu, “Woguo yusanwai zizhin de xieyi wenti” [Some problems on the extra-budgetary funds in our country], Fuyin baokan ziliao—caizheng-jinrong [Copied materials of newspapers and magazines—public finance and banking], 1982, No.4, p.46; Zhang Feng and Ge Tianming, “Dui yusanwai zizhui yao jiaqiang xingguan kongzhi” [We should reinforce the macro control of the extra-budgetary funds], Jingji guanli, No.6, pp.22–23.
37 Midori Kizaki, “Kyō no jūgyōin ni taisuru bunpū to kakkaku” [Distribution to employees by enterprises and the reform], in Chūgoku no keizai kakkaku, ed. Koji-ma, p.46.
42 Ma, ed., Zhongguo jinri, p.579.
45 Zhou, ed., Dangdai Zhongguo, p.75.
48 As expressions of the chaotic situation over the hiring of temporary workers in 1957 the following are cited: (1) temporary workers were recruited when there were surplus regular employees, and (2) temporary workers hired without contracts or hired on a short term basis were made to work over a long time, thus making contractual arrangements meaningless. For details, see Kyoichi Ishihara, “Toshi to nōson tono kensetsu” [Chinese urbanization and rural construction], ed. Chugoku no keizai kakkaku, ed. Koji-ma, p.282.
51 Zhou, ed., Dangdai Zhongguo, pp.146–47. It is said that Liu Shaoqi proposed the “double-track labor system.” He first presented the plan at the enlarged conference of the Political Bureau of the Central Committee of the Communist Party of China
in May 1958. He again proposed it at the working conference of the Central Committee of the CPC in May-June 1964 (Tsuneto Yamamoto, "1960 nendai ni okuru rōdō, kyōiku, kashō no sammi-ittai-teki seisaku tenkai to sono hasan" [The development of the trinity policy of labor, education, and rustication in the 1960s and its failure], Gendai Chiugoku no zasetsu [Failure of modern China], ed. Mitsuyuki Kagamimi [Tokyo: Institute of Developing Economies, 1985], p.149). According to Yamamoto, Zhou Enlai encouraged the promotion of temporary workers to regular workers in a State Council's notice (Guowuyuan tongzhi) in 1963. Liu Shaoqi countered this move by issuing an instruction in 1964 in favor of more temporary employees and less regular employees. Ma Wenrui, then Minister of Labor, is said to have tried to implement Liu's instruction.

2
Planning and the Market

Introduction
In China's pre-reform period, planning management was based mostly upon the classification of products into wuzi (materials and equipment) and shangpin (commodities). In particular, control over the production and distribution of wuzi was maintained less by economic regulators such as prices and more by the direct means of mandatory planning. However, while the framework of the unified distribution system of central government remained unchanged, the share of centrally planned distribution in the total production of wuzi declined considerably in the 1970s. Along with this change, the role of mandatory administrative planning in the national economy diminished in importance. This was a major factor in bringing about increased decision-making powers for enterprises, and in introducing elements of the market mechanism and other facets of economic reforms since the end of the 1970s. The model of reform which China aims at will have to reflect these changes.

Decline in the Role of Central Planning

Wuzi and Shangpin
In Western countries the goods produced by economic activities are roughly classified into three groups: producer goods (materials, energy, and the other intermediary goods), capital goods (durable goods used as the means of production such as machines), and consumer goods (goods consumed mainly by households). When studying the market and planning in China, it is important to
understand that the methods of planning management are classified into two
groups depending on whether the types of goods produced are "materials and
equipment" or "commodities." The former are the producer and capital goods
(hereafter referred to as "producer goods") distributed among state-owned
enterprises and are known as wuzi. The latter, known as shangpin, are the
commodities sold between state-owned enterprises and collective-owned enterprises
between state-owned enterprises and collective-owned enterprises.

Managing the Distribution of Wuzi

In the planning management of wuzi materials and equipment, these are clas-
sified into three categories, which were established in the 1950s and used to
regulate the distribution of materials and equipment until the 1980s. The three
categories are:

1. Yilei wuzi (materials and equipment under category I) or tongyi fenpei wuzi (materials and equipment under unified central planning): The State Plan-
ning Commission supervises the State Bureau of Materials and Equipment in
preparing balance charts and distribution plans for these goods. The goods un-
der this category include coal, pig iron, rolled steel, copper, aluminum, lead, zine, tin, copper materials, aluminum materials, lead materials, sulfuric acid,
concentrated nitric acid, caustic soda, soda ash, cement, lumber, automobiles,
heavy oil, rubber, power machines, and metalworking machines.

2. Erlei wuzi (materials and equipment under category II) or zhongyang fenpei wuzi (materials and equipment under distribution by the ministries of industry of the central government): These are goods distributed by
the government organizations concerned with industrial matters under the
State Council. The specialized producer goods mainly used by a particular minis-
try fall under this category. These include mineral ores, oil boring machines,
the spinning machines and specialized spinning equipment distributed under the
Ministry of Textile Industry, and the ferrous alloys and coke distributed under
the Ministry of Metallurgical Industry. Also included are producer goods of
relatively high importance which are used in common by the various ministries,
for example, newsprint, trucks, and chemical and industrial fuels.

3. Sanci wuzi (materials and equipment under category III) or dafang guanli wuzi (materials and equipment managed locally): These are goods which are
managed by the material and equipment sectors of the provinces (which includes
municipalities directly under central authority and autonomous regions), spec-
sial administrative districts or prefectures (including provincially administered
cities), and counties. There are over 10,000 goods in this diverse category as
This is due in part to the transfer in 1958 and 1970 of enterprises under the 
First, the amount of producer goods held by the local regions has inc’
creased. Figure 2-3 shows the percentage of key materials and equipmen
to which are subject to unified distribution, the percentage of 
distribution of materials and equipment in category I which enabled the cen-
tral government to carry out its centralized planning.

As can be seen from Table 2-1, the number of items in the three wuzi categories 
has fluctuated sharply. Among these wuzi items, the important materials and 
equipment produced by the state-owned enterprises are incorpored into the 
state plans over the entire process from production to purchasing, supply, and 
consumption. Prices for wuzi are fixed by the government and therefore do 
ot enjoy the barometer function played by pricing which fluctuates in accor-
dance with the supply and demand situation in the market. Moreover, the 
parameter function of prices, wherein supply and demand is adjusted in accor-
dance with changing market prices, does not substantially work. This was par-
ticularly true under the system prior to 1978 where the assortment of wuzi goods 
produced, their production volumes, and even the raw materials, fuel, and equipment 
used for their production were specified in the plans, and enterprises had 
very little discretion over adjusting the production volumes to match the prices 
of individual items.

Materials and equipment under category I in particular were centrally managed 
by the State Bureau of Materials and Equipment in accordance with distribu-

tion plans. Furthermore, the items classified therein were mostly important 
producer goods which supported the national economy, and it was the unified 
distribution of materials and equipment in category I which enabled the cen-
tral government to carry out its centralized planning.

Figure 2-3 shows the percentage of key materials and equipment in category 
I which have been controlled under the unified distribution system. A compar-
isom of the percentage of unified distribution for coal, rolled steel, cement, and 
lumber to total production, can be made for the period between the 1960s and 
1980s. The absolute amount of unified distribution has increased, but the per-
centage to total production has fallen. This indicates that the range of sectors 
which can no longer be controlled by the centralized distribution of the govern-
ment has expanded. Or to put it the other way around, for much of the materi-
als and equipment which are subject to unified distribution, the percentage of 
actual distribution by the central government has fallen. This situation has come 
about for the following reasons.4

First, the amount of producer goods held by the local regions has increased. 
This is due in part to the transfer in 1955 and 1970 of enterprises under the
jurisdiction of the central government to that of the local authorities. Moreover, the production of rolled steel, cement, coal, and the like by small-scale enterprises under local control has increased considerably.\(^5\) For example, production by key cement factories in the unified distribution system rose only 2.8 fold from 1958 to 1982, while the production of local cement factories rose as much as 257 fold during the same period. The production of key coal mines rose 2.2 fold from 1963 to 1980 while that for local coal mines rose 5.7 fold.

The distribution of wuzi was sometimes forbidden to go across boundaries of territorial jurisdictions, administrative agencies, or owners. According to a regulation, the Bureau of Materials and Equipment could not supply producer goods to the former rural communes- and brigade-run enterprises (shedui qiye) or to urban collective-owned enterprises which have been making great strides since the 1970s. This regulation would have made it impossible to incorporate the production of local and small-scale industries into state plans.\(^6\)

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TABLE 2-1
THE NUMBER OF ITEMS IN THE THREE WUZI CATEGORIES

<table>
<thead>
<tr>
<th>Year</th>
<th>Category I</th>
<th>Category II</th>
<th>Category III</th>
<th>Year</th>
<th>Category I</th>
<th>Category II</th>
<th>Category III</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>8</td>
<td></td>
<td></td>
<td>1964</td>
<td>370</td>
<td>222</td>
<td></td>
</tr>
<tr>
<td>1951</td>
<td>33</td>
<td></td>
<td></td>
<td>1965</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1952</td>
<td>55</td>
<td></td>
<td>5,000</td>
<td>1972</td>
<td>49</td>
<td>168</td>
<td></td>
</tr>
<tr>
<td>1953</td>
<td>112</td>
<td>115</td>
<td></td>
<td>1973</td>
<td>50</td>
<td>567</td>
<td></td>
</tr>
<tr>
<td>1954</td>
<td>140</td>
<td></td>
<td></td>
<td>1974</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1955</td>
<td>162</td>
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<td>565</td>
<td>1975</td>
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<tr>
<td>1956</td>
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<td>636</td>
<td>1976</td>
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<td>1958</td>
<td>336</td>
<td></td>
<td></td>
<td>1978</td>
<td>156</td>
<td>581</td>
<td></td>
</tr>
<tr>
<td>1959</td>
<td>67</td>
<td>218</td>
<td></td>
<td>1980</td>
<td>256</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1960</td>
<td>75</td>
<td>342</td>
<td>581</td>
<td>1961</td>
<td>565</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1961</td>
<td>87</td>
<td>416</td>
<td>561</td>
<td>1962</td>
<td>70</td>
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<td>345</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>1963</td>
<td>256</td>
<td>260</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

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Second, discipline of planning management has become lax. Even when production targets under the plan are achieved in excess of the norm, there are cases where the targets for supply are not met, production becomes concentrated in relatively high-priced items, or products are sold to production enterprises or construction units outside of the plan at higher than plan prices.

A third factor is one inherent to centralized planning systems. As pointed out by Ellman, when the central authorities are ignorant to some extent about the overall economic situation, and when the techniques for data processing are inadequate, direct centralized planning becomes incomplete and thus inefficient.7

Finally, the increase in production volumes and the diversification of production items have resulted in much greater complexity in the economy. At the start of the 1950s, when controls over materials and equipment began, there were only eight types of wuzi: rolled steel, lumber, coal, cement, soda ash, copper, machine tools, and hemp bags. But, the number of items gradually increased until by 1981 the wuzi under the unified distribution system and those distributed by the ministries of industry numbered 837 items.8

The Distribution of Shangpin
Classification
Shangpin, like the previously mentioned wuzi, are classified into three categories depending on the differences in management methods. The first such method was set forth in the 1959 Shangpin fenji guanli baofa [Procedures for the management of classified commodities].9 This covered the following goods:10

1. Yilei shangpin (category I commodities): These are commodities which are controlled by the ministries and commissions of the State Council under the tonggou tongxiao system of state monopoly for purchase and marketing. They include grain, oil-bearing crops, oil and fats, cotton, cotton yarn, cotton fabric, gasoline, diesel oil, lubricating oil, and coal.

2. Erlei shangpin (category II commodities): These are commodities which are controlled by the ministries and commissions of the State Council under the tonggou tongxiao system of purchase through the state monopoly, the paigou system of purchase by state quotas, and the baoxiao system of exclusive sales. These include live swine, fresh eggs, jute and hemp, ramie, silk cocoons, wool, leather, hemp rope, chemical fertilizer, agricultural chemicals, wires, nails, sewing machines, bicycles, some drugs and materials for herbal medicines.

3. Sanlei shangpin (category III commodities): These are goods for which yigou yixiao (negotiated purchase and marketing), xuangoti (selective purchases), shengchan danwei xiaoyi (sales through a production establishment’s own channels), and other methods of purchase and sales are allowed. They include sundry goods, marine produce and fruit produced in regions other than main production regions (marine produce and fruit of main production regions fall under category II), and herbal medicine materials which are collected from widespread areas and whose yield is small.

According to the 1959 classification of commodities, there were 38 category I commodities and 293 category II commodities. Subsequent revisions to the classification reduced the numbers significantly. Among category I commodities, the State Council controls the purchasing, sales, transportation to and from provinces, import and export, and the storage of grain, edible oil, cotton, cotton yarn, and cotton fabric. The council controls the targets or norms for the distribution of gasoline, diesel oil, heavy oil, and lubricating oil to economic sectors and for import and export. Category II commodities are controlled by the central supervisory ministries of the State Council regarding the targets for distribution to the different regions and sectors and import and export.

The prices for the purchase and sale of category I commodities under the state monopoly system are planned prices set uniformly by the central government. The same is true for purchases under the state monopoly by state quotas for category II commodities. Even some of the category III commodities are controlled by planned prices when they involve sales by the state-owned commercial sector.

Distribution of industrial goods
Among industrial goods, all of the consumer goods and a portion of producer goods sold to the agricultural sector are distributed as shangpin. During the 1960s and 1970s the commercial sector purchased manufactured products from industrial enterprises through the following two methods.

1. Tonggou (purchasing under the state monopoly system)—category I commodities were purchased in the prescribed types and quantities. Mandatory legal sanctions were applied.

2. Baoxiao (exclusive sales)—category II commodities and some category III commodities were subject to exclusive purchasing and sales. Industrial enterprises were not able to sell products on their own. The difference from tonggou purchases under the state monopoly was that no mandatory legal sanctions were involved.

In the 1950s there were also jiaagong and dinghuo (the placing of state orders with private enterprises for the processing of materials or the manufacture of goods), but these systems disappeared with the conversion to joint state-private ownership in 1956.

New purchasing systems began to be introduced in 1980, followed by considerable diversification of purchasing methods in later years. At present there are four main systems.11

1. Tonggou tongxiao (purchases and sales under the state monopoly system)—The industrial sector is not allowed to sell its own products, not only that portion of production targeted under the plans, but also the portion of production over and above the plans. Covered under this are eleven commodi-
ties, including cotton yarn, cotton fabric, and petroleum products.

(2) *Jihua shougou* (planned state purchases)—Industrial enterprises are allowed to independently sell portions of production that are over the plan targets. The commercial sector is allowed to engage in negotiated purchases. Covered under this system are twenty-four commodities, including sugar, cigarettes, chemical fibers, woven wool fabrics, woven silk fabrics, towels, wool yarn, rubber shoes, matches, soap, pencils, watches, and bicycles.

(3) *Dinggou* (purchases by order)—Purchasing contracts are concluded by negotiation between the production enterprise and the distribution enterprise. Covered under this system are eighteen commodities including powdered milk, brand-name wines and liquors, sewing needles, spirits, wines, fabric shoes, aluminum pots, and television receivers.

(4) *Xuangou* (selective purchases)—These are for category III commodities for which there are no unified standards. Purchases are made from industrial enterprises in consideration of market supply and demand.

**Purchasing methods and prices for agricultural products**

(a) Three purchasing methods

The purchasing methods for agricultural products are determined by which of the three *shangpin* categories a product falls under. At the present time there can be several different purchasing methods employed for the same commodity. However, the state monopoly methods established in the 1950s are still being used for a few important commodities. These are classified into the following:

(1) *Tonggou* (purchases under the state monopoly system)—Category I agricultural products: Under the state monopoly purchasing system, peasants are allowed to retain only a portion of their production for their own needs, such as rice for home consumption, for seed, feed, and for stockpiling. They must sell all of the rest of their produce including that for paying agricultural taxes to the state designated commercial sector at the unified purchasing prices set by the state. Private merchants are banned from purchasing from the peasants and thus the state commercial sector enjoys a monopoly. The commodities belonging to category I are covered by this state monopoly system. Grain and oil-bearing crops were placed under this system in November 1953 and cotton in September 1954. Lumber was reclassified as a category I agricultural product in March 1981.

(2) *Paigou* (purchase by state quotas)—Category II agricultural products: This system was first applied in 1955 to the purchase of swine. It was expanded to cover other products in subsequent years (particularly in 1959). At the present time, the cattle and sheep of livestock raising regions, as well as tobacco, hemp, silk cocoons, tea, lacquer, tung oil, and other category II commodities are covered. The state-designated commercial sectors use administrative means to allot a fixed quantity of these agricultural products to be delivered by the former people's communes and production teams or the present townships and villages.

(3) *Yigou* (negotiated purchases)—Category III agricultural products: The state sets no mandatory production levels for these goods. Transactions are established by negotiation between the commercial sector and the producers. Goods falling under this category include regional specialties, subsidiary products for daily use, some fruits and dried vegetables, seasoning, wild fibers, miscellaneous oil-bearing materials, medicinal materials, and other category III commodities.

The above three purchasing methods have been used to regulate the volumes and prices of agricultural products in accordance with their importance to the national economy. For the extremely important category I commodities like grain, oil-bearing crops, and cotton, the state has exercised a monopoly over the distribution process. These three commodities account for 45 per cent of the total value of agricultural and sideline commodities purchased by the state-owned commercial sector.

(b) Purchasing methods for grain

To better understand the effect of prices on agricultural production in China, we will look at the purchasing methods and prices for grain. Grain is a category I agricultural product. As mentioned above, in the 1950s grain was totally under the *tonggou* system of purchases within the state monopoly system. In subsequent years, various other methods came to be allowed, such as...
the chaotic system of higher price purchases for production beyond state quotas (in some regions, including a zenggou system of additional purchases for production beyond state quotas, a chaogou, chaochaochangou, and other additional purchase systems) and the yigou system of negotiated purchases (see Figure 2-4). Differences in purchasing prices appeared depending on whether grain was purchased through chenggou jishu (fixed quotas of state grain purchases), through chaogou, or through yigou.

The purchasing prices through chenggou jishu have been raised by wide margins three times in the past: 25 per cent in 1961, 17 per cent in 1966, and 20 per cent in 1979.

Under the chaogou system, after chenggou jishu has been met, grain is purchased at higher prices. The price for purchases beyond state quotas, unlike with chenggou jishu, is determined each year by the size of the harvests (jinian yiding). These above-quota purchases add a fixed premium above the chenggou jishu purchasing price (pingsia). The amount of the premium has been gradually raised from 10 per cent in 1960 and 1961, to 12 per cent in 1965, 30 per cent from 1971 to 1978, and 50 per cent since 1979.

The chenggou jishu purchases and above-quota purchases are made under state plans and so are both included in the chenggou state grain purchases in the broad sense of the term. The government also makes purchases through negotiations with peasants. For the peasants, the lower the price for chenggou jishu, the better it is for above-quota higher priced purchases and negotiated purchases. For this reason, the rate of fulfillment for chenggou jishu quotas is not very good. The absolute volume of grain purchased under chenggou jishu quotas fell from 35 million tons in 1979 to 34.35 million tons in 1980, then 30.4 million tons in 1981; nevertheless, the rate of fulfillment for the quotas fell from 90 per cent to 81 per cent and then 80 per cent.

As clear from Table 2-2, the percentages of above-quota purchasing prices and negotiated purchasing prices to total purchases have risen each year. The portion of production which the government can procure by administrative command, i.e., the chenggou jishu quotas, has fallen and the portion which must be procured through raising purchasing prices has increased. This shows that the old policy of securing commodity crops by administrative fiat was already reaching a dead end. Finally, in 1985, the government scrapped the system of compulsory procurement and moved to a system of purchases by order. For the government to secure the same amounts of grain it has in the past, it will now have to increase the amount of its negotiated purchases.

As mentioned above, purchases of agricultural products in China, especially purchases of grain, have been guided less by prices and more by the administrative control of production. As clear from many Chinese editorials since the end of the 1970s, prices have not been determined in accordance with changes in costs; instead China has given priority to price stabilization and to closing income disparity. The detriment of this policy, however, has been the deficient allocation of resources.

Even before the hikes in the late 1970s of the government purchasing prices of agricultural products, there were times when the Chinese emphasized guidance through prices or indirect planning. These occurred in the late 1950s and early 1960s during periods of economic readjustment. However, these policies were not long maintained. One reason for this was because the Chinese economy lacked leeway for the allocation of resources through the price mechanism. Given the diversity in per peasant grain production in the 1950s from 245 kg (Hebei Province) to 905 kg (Heilongjiang Province), the chronic shortages, and the supplies required for the burgeoning urban population, the tough administrative controls clamped on agricultural production were only natural.

Along with the hikes in the government purchasing prices of agricultural products since 1979, the government has found itself faced with soaring price subsidies which have reached around 20 per cent of fiscal expenditures. The total sum of price subsidies rose from 9.4 billion yuan in 1978 to 37.0 billion yuan in 1984. Subsidies for the purchase and sale of agricultural products alone rose from 100 million yuan in 1957 to 2 billion yuan in 1965, then to 5 billion yuan in 1978, and 20 billion yuan in 1983. Of this, over half went for grain and edible oils. The bill for past price policies is being paid out in the form of price subsidies.

Economic Planning and the Market
The Model of Reform
China’s economic reforms carried out since the end of the 1970s can be organized along two axes. One is the decentralization of power to local authorities and enterprises. Of particular importance was the enlargement of decision-making powers for enterprises. In the area of enterprise capital formation, China has gone through several stages such as the introduction of an enterprise fund system, a profit retention system, and a corporate income tax...
The basic direction of all these is toward ensuring funds for enterprises that can be used at their own discretion and in accordance with their individual performance.

The other axis of economic reform is the introduction of the market mechanism. Previously in the economy mandatory plan targets were used to administratively allocate resources. The introduction of the market mechanism reduces such mandatory plan targets and simultaneously aims at allocating resources through utilization of prices, interest rates, taxes, and other economic regulators. These two axes are not set apart from each other. The realization of enlarged decision-making powers in enterprises management cannot be separated from the introduction of the market mechanism. But I have differentiated between these two axes because it is necessary and convenient for explaining the transition of China's economic system. Under the old system China's economy seesawed between periods of centralized control such as during the First Five-Year Plan and during times of adjustment, and periods of decentralization to local authorities, such as during the Great Leap Forward, and the Cultural Revolution. In all periods, however, the economy was managed through "administrative tools," and in this way they all remained the same. The present economic reform differs in that it calls for decentralization to enterprises and for management by "economic tools."

Price reform as one part of economic reform has also been carried out along the two axes. The vertical axis in Figure 2.5 extends from centralized government control to management by individuals and corresponds to the change of economic centralization to decentralization. The horizontal axis shows the change of economic management from administrative controls to market principles. Centralized price determination and rationing (which even limits the amount that can be sold) are the strongest of administrative controls. Between this and free pricing at the other end of the spectrum lie various other forms of price controls. Economic reform since the end of the 1970s has aimed at the decentralization of authority to enterprises and the introduction of market principles. One can question how much progress China has actually made in this respect, but the economic model it targeted in the 1980s can be positioned near the center of Figure 2.5. Since 1992 China has set a long-term objective of realizing an overall market economy.
in industry, commerce, trade, agriculture, etc. organized by the authorities in the production areas in charge of supervising commodity prices and the authorities in charge of supervising administration of the industrial and commercial sectors; “negotiated prices of neighboring areas” which are determined by the relevant government authorities and enterprises in neighboring regions; “unified prices of industry” which are determined through negotiations among production and merchandising units in an industry and submitted for approval by the government authorities in charge of supervising commodity prices.

Government-determined prices, which are decided through the administrative relationship between the supervisory organization and the subordinate enterprise, have the mandatory force of law; government-guided prices are semi-mandatory which means that they are also semi-free and therefore open to a degree of negotiation.

From Table 2-3 it can be seen that “negotiated price” (yijia) can sometimes be considered a government-guided price and sometimes a market-adjusted price. For the above-mentioned “negotiated prices of production areas,” “negotiated prices of neighboring areas,” and “unified prices of industry,” the supervisory organizations participate in the negotiations, therefore these belong in the area of government-guided prices. On the other hand, the prices determined by production units and business units through negotiations on their own, or through negotiated prices within an industry which do not require the approval of the authorities in charge of supervising commodity prices, fall under market controlled prices.

**Progress in Conversion to a Commodity and Market Economy**

**“Decision on reforming the economic system”**

The “Decision of the Central Committee of the Communist Party of China on reforming the economic system,” adopted at the Third Plenary Session of the 12th Central Committee of the Communist Party of China held in October 1984, summarized the basic feature of the state planning system aimed at as “a planned commodity economy under public ownership.” Of note here was that the party and the government officially defined socialism as a “commodity economy.” This was a tremendous reversal of China’s past interpretation of socialist theory.

In the debate over state planning and the market, which has gone on since 1978, much had already been said about the necessity of utilizing in socialism of the functions fulfilled by commodities and currency, but never had socialism been defined as a “commodity economy.” Based on critical study of classical Marxism, open discussion took place over the inseparability of Chinese socialism and a commodity economy. This happened in an article by then director of the Chinese Academy of Social Sciences, Ma Hong, and released in two parts about a month after the third plenary session. The two concepts of “socialism” and a “commodity economy,” which seemingly could not be linked in traditional classical socialist theory, were treated as inseparable in Ma Hong’s paper.

The theoretical definition of a “planned commodity economy under public ownership” reflects the two directions of change which are now occurring in the Chinese economy. One is the process of collapse of the system of self-supply and self-sufficiency through the spread of commodities and currency and can be termed the conversion to a commodity economy. The other is the introduction of the market mechanism into the planned economy and may be called the conversion to a market economy. Along with the progress of economic reform and the open-door policy since the end of the 1970s, there has been striking progress in the conversion of China to a commodity and market economy. For this reason it is no exaggeration to say that a qualitative change is now taking place in China’s economic system.

**Conversion to a commodity economy in the countryside**

In urban areas and the mining and manufacturing sector, there has already been close to 100 per cent conversion to a commodity economy. At the present time, the conversion from self-supply and self-sufficiency to a commodity economy is only an issue in the rural areas.

Table 2-4 shows the percentage of self-supply and that of purchases for commodities to total expenditures by peasants for daily life. From the table it can be seen that the percentage of purchases for commodities rose sharply from 1978 to 1983. As of 1978, the percentage of self-supply was still larger, but this situation had changed completely by 1983.

However, the rate of self-supply has risen in fuel consumption. In the rural areas of China, firewood and stalks of farm produce (sorghum, corn, rice, etc.) have traditionally been used as the principal sources of fuel. Even today 80 million peasants, or 47.7 per cent of all peasants in China, suffer from shortages
Let us now examine how far the market mechanism has been introduced into the economy through three routes for the distribution of commodities.

The first is the pricing system for producer goods distributed among state-owned enterprises. As already mentioned, there has been a great fall since the 1970s in the percentage of producer goods distributed under central government plans. Some of the goods that fall outside of central government plans are transferred to the control of local governments. However, not all of these goods are incorporated into the local plans. For example, 50 per cent of total coal production is left out of the central government distribution system. Half of this is produced by locally administered state coal mines, but the other half is produced by collectively or individually managed mines and is sold at market prices.

According to a paper published in 1985, producer goods outside of the central government's distribution plans (of total production, 50 per cent of coal, 40 per cent of rolled steel, 60 per cent of lumber, and 75 per cent of cement) were in reality distributed at market prices. Even among producer goods produced by coal mines under the unified central planning system, enterprises are allowed to sell on their own the portion of their production exceeding the targets for production plans. The prices for such sales can be determined through negotiations among the enterprises concerned. In the case of rolled steel produced by state-owned steel-making plants, the rate of such independent sales reached 23.5 per cent of total production by these plants in 1980 and 30.2 per cent in 1985.

The second route is the price of agricultural products sold by peasants. In 1985 the value of agricultural and subsidiary products sold from rural to urban areas reached 168 billion yuan. This was 47 per cent of total agricultural and of firewood for fuel for three to six months of the year. For this reason large amounts of crop stalks, leaves, roots, animal waste and the like are used as fuel for cooking and heating. In the past crop stalks were owned by the collective (production team), but now under the contract responsibility system based on the household, these can be used by individual households. As a result the rate of self-supply in fuel has risen. The types of crops cultivated can now also be decided freely by the peasants, so a conversion may be underway in some regions to crops with long stalks.

Reietsu Kojima gave as one of the reasons for the failure of the Great Leap Forward the collapse of the public dining halls due to fuel shortages and the crumbling of the collective economy. Under the household management system now spreading in the rural districts, it is noteworthy that the rate of self-sufficiency in fuel has risen again. Fuel shortages weakened the collective economy during the Great Leap Forward. At the present stage, fuel shortages may be said to be strengthening the foundation of the household management system.

Degree of conversion to a market economy

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PLANNING AND THE MARKET

TABLE 2-5

<table>
<thead>
<tr>
<th>Composition of Sales of Agricultural and Subsidiary Products</th>
<th>(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State listed prices</td>
<td>84.7</td>
</tr>
<tr>
<td>Higher prices for above quota purchases</td>
<td>16.7</td>
</tr>
<tr>
<td>Negotiated prices</td>
<td>6.7</td>
</tr>
<tr>
<td>Free market prices</td>
<td>10.2</td>
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<tr>
<td>84.7</td>
<td>71.7</td>
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<tr>
<td>16.7</td>
<td>17.9</td>
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<td>6.7</td>
<td>9.5</td>
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<tr>
<td>10.2</td>
<td>8.2</td>
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</table>


Note: Higher prices for above quota purchases prices are by definition included in state listed prices. However, the state listed prices in this table mean the lowest purchasing prices, i.e., the pingjia. In 1985, the prices for purchases by order are also included in the percentage of 32.1.

As can be seen from the above, the market mechanism has been introduced into the distribution routes of a variety of commodities. But industrial manufactures which form important producer and consumer goods still remain under the strict control of state planing. Likewise charges for movies, public baths, transportation, and other services are predominantly set by the state. However, economic reform has definitely increased the role of the market in the Chinese economy and the trend is expected to develop in the future.

Multiple Price System

The establishment of multiple prices

Since the pre-reform period, the prices of producer goods produced by the raw materials and energy sectors have long been lower than those of products produced by the manufacturing sector, and this has been the major reason for the deficits incurred by enterprises in the raw materials and energy sectors. The government, as a matter of policy, deliberately kept profit margins on producer goods down, and one of the aims of price reform commencing at the beginning of 1980s was to raise the government's fixed prices for such goods. At the same time, the government moved to allow the sale of producer goods produced in excess of plan quotas at premium or market prices. The result was the appearance of multiple price levels between the lowest price (the government's standard price) and the highest price (the market price). Some enterprises abused the eased controls and diverted goods to the producer-goods markets or black markets without even working to achieve production targets set by the government, or made use of monopolistic conditions to sell their goods at high prices.

The "Provisional regulations on further extending the decision-making power of the state industrial enterprises," issued by the State Council on May 10, 1984, gave permission for the independent sale of a portion of the producer goods produced by state-owned enterprises and thereby gave formal recognition to the already existing multiple price levels. Up to 20 per cent variations in prices were allowed for "excess production" of rolled steel, pig iron, copper, aluminum, lead, zinc, tin, coal, cement, sulfuric acid, concentrated nitric acid, caustic soda, soda ash and rubber, and for 2 per cent of the planned production of rolled steel.
Following this ruling, the government gradually enlarged the percentage of overall output which enterprises could sell independently and in 1985 removed the 20 per cent restriction on the price differentials allowed. Thereafter the government extended this multiple price system to include such important producer goods as primary and secondary energy, petroleum products, coke, lumber, metal materials, sheet glass, and mineral products.

The following reasons account for the spread of multiple prices for producer goods since China began its economic reforms.

1. The scope and application of planned prices has been reduced. This is related to a reduction in the ratio of goods distributed by the central government to total production. Comparing the ratio in 1962 to that in 1982, the percentage of coal delivered by the state under unified distribution fell from 75 per cent to 51 per cent, that for rolled steel from 95 per cent to 53 per cent, that for cement from 71 per cent to 25 per cent, and that for lumber from 63 per cent to 57 per cent.

2. Even enterprises covered by the unified distribution plans of the central government are now able to sell their excess production at market prices.

3. The prices for goods produced by local state-owned enterprises are managed by the local governments.

4. There are almost no price controls imposed on the collective or private operations of peasants, including rural enterprises.

5. "Producer-goods trade centers," which engage in market transactions of producer goods, have been established all over China and even allow participation of out-of-province enterprises and collectively and privately operated enterprises.

6. The supply of producer goods cannot keep up with demand, resulting in the formation of a black market.

When compared with the old system of a single, centrally controlled price, this type of multiple price system plays a positive role in providing enterprises with incentives to produce and in contributing to market vitality. But, on the downside, it also obstructs the evaluation of business performance, planning, and optimal distribution of resources, and in some ways it promotes negative speculative actions such as short selling and multiple resale.

The actual situation

The spread of multiple price levels is also a reflection of the multilayer structure of the economy. As exemplified by the case of coal, the structure is comprised of centrally controlled coal mines, coal mines under the jurisdiction of local governments, and collectively as well as privately operated coal mines.

We will now take a look at the state of the multiple price situation for individual producer goods.23

(1) Oil

The Daqing Oil Field was discovered in 1960. In that same year, China produced a total of 4.19 million tons of crude oil, for a self-sufficiency rate in oil of 42.5 per cent. The government set a new nationwide price for crude oil in March 1961 which took into consideration regional differences and costs. The price was determined in relation to the Soviet price system of the late 1950s.

From 1961 to 1970, the Chinese maintained an average price for crude oil of 130 yuan per ton. This was reduced 20 per cent to an average 103 yuan per ton in the 1971 price revisions. This standard price remained fixed until 1988. Meanwhile, the cost of sinking oil wells rose two-fold between 1975 and 1985. Survey costs rose 2.5-fold and overall production costs 1.9-fold in this ten-year period. With costs climbing and the price of crude oil held down, almost all oil fields ended up running deficits. It has been reported that they cannot meet costs today unless the price of crude oil rises to at least 200 yuan per ton.

From 1983 the government set up a contract system for crude oil production which allowed the oil fields to export or sell domestically at international market prices any crude above their contract obligations. This led to the appearance of so-called "high priced oil," and a double price standard. At the time, the Daqing Oil Field was selling such "high priced oil" at 650 yuan per ton, while the Shengli Oil Field and the other oil fields were selling it at 520 yuan. After the price revisions of 1983 and 1985, the Daqing Oil Field reduced prices to 545 yuan and the Shengli Oil Field to 475 yuan, but these prices were still roughly five times the government's standard price.

In February 1988, both the government's standard price and the price of "high priced oil," were raised by 10 yuan.24 Needless to say, such a small price hike failed to have much of an effect, and in 1988 the Daqing Oil Field ran a deficit for the first time since it was opened in 1960—26.12 million yuan. In 1989 the standard price was raised by 27 yuan. The result was that various kinds of oil price appeared as shown in Table 2-7.

Among oil products, we have the example of heavy oil for industrial use. The government's fixed price is, as of the end of the 1980s, 115 yuan per ton, while the government's guided price is 145 to 330 yuan, and the market regulated price is as high as 490 yuan.

(2) Steel

The prices of steel products are also multiplying. There is the standard distribution price set by the government, the price used for local government orders, premium import prices, floating prices controlled by the Ministry of Metallurgical Industry, and private sales prices for production in excess of plan volumes (market-regulated prices). The government's standard distribution price for rolled steel was 700 yuan per ton, while the market regulated price was 1,700 yuan and the premium import price was 2,100 yuan (800 yuan of which went for customs duties and the consolidated industrial and commercial tax) around 1987.25 If one also includes the black market prices, the result is a very diverse price structure.

The overheating of the Chinese economy from 1987 to 1988 caused a shortage in the supply of raw materials and energy compared to the increase in demand. Sichuan Province set the price for local government occasional orders
Among the various forms of energy, the Chinese government has kept the

higher than the centrally controlled prices in order to prevent the outflow of raw materials. Table 2-8 shows the prices of some steel products in Sichuan Province. 16 MnR medium plate, which was more expensive than 16 Mng medium plate in the centrally controlled price table, became cheaper than 16 Mng medium in the province occasional price table because of the difference between premium rates.

(3) Cement

As already explained, in 1985 the government gave permission for production units to sell at market prices the portion of their producer goods produced in excess of state plans. In general this measure led to the establishment of three prices for the same grade of cement products: the standard distribution price of the central government, the distribution price of the local governments, and the market price. Meanwhile, the portion of cement distributed by the central government has dropped with each passing year. In 1982 it accounted for no more than 1/4 of the total production volume. At the end of 1985, the premium rates for the same grade of cement products: the standard distribution price of the central government, the distribution price of the local governments, and the market price. Meanwhile, the portion of cement distributed by the central government has dropped with each passing year. In 1982 it accounted for no more than 1/4 of the total production volume. At the end of 1985, the ratio of the volume of cement sold under the three prices was 15:1:25. At the end of September 1986, this had shifted to 1:1.24:1.6. The price differential was about 1.57:1.

(4) Lumber

Looking at the nation as a whole, there were 50 million cubic meters of lumber traded as a commodity in 1985. Of this, 17 million cubic meters was distributed within the scope of state plans at a price of 140 yuan per cubic meter (the price after hikes in October 1986). On the other hand, there were 13 million cubic meters of southern lumber, 9 million cubic meters of northern lumber, and 9 million cubic meters of imported lumber distributed outside of the plans at an average price of 220 yuan per cubic meter. The price differential was about 1.57:1.

(5) Coal

Among the various forms of energy, the Chinese government has kept the
strongest grip on the price of coal. Since the establishment of the People’s Republic, there have been only four price revisions. Since 1985 the price has been raised to 24–25 yuan per ton, but this is still extremely low compared with international prices. Production was stimulated in 1983 when the authorities allowed a 100 per cent premium to be tacked onto the government’s fixed price for coal produced in excess of the plans. Since that time, multiple price levels for coal have spread nationwide.

As with other producer goods, the percentage of coal distributed under the control of the central government had fallen and was only 46 per cent of total production in 1989. The remaining 54 per cent was split between 2,000 local governments and 79,000 collective and private mines.26 In the middle of the 1980s Shanxi coal sold for over 60 yuan per ton when transported to Shanghai. On the other hand, the same coal, from centrally controlled mines, sold for only 30 yuan in Shanxi province. And coal from rural mines sold for even less around 10 yuan. In general, therefore, the energy conservation investment of the inland provinces such as Shanxi must be less than that of the coastal provinces of China.

Multiple prices resulting from open-door policy

When foreigners use transportation, hotels, and other facilities in China, they are asked to pay in foreign exchange certificates (issued starting April in 1980). Also, while enjoying no better train seats, hotel rooms, and other services, they have to pay several times the rates of native Chinese. In other words, there are special higher charges for foreigners. Since April 1985, the room and dining charges for hotels of Chinese-foreign joint ventures (equity joint ventures or contractual joint ventures) have been left to the decision of the individual hotels.27 The rates for state-run hotels, on the other hand, have remained as officially set. This is resulting in further diversity in prices.

Conversely to the above, there are also cases where prices are lower when foreign exchange certificates are used. In general, the friendliness stores around the country are set up for foreign and overseas Chinese customers and ask for purchases to be paid for in foreign exchange certificates (or renminbi with foreign exchange certifications attached). Depending on the product, two prices are sometimes displayed: one for renminbi and one for foreign exchange certificates. In such cases, the price for foreign exchange certificates were 20 to 30 per cent lower in about the middle of the 1980s.

The above-mentioned situation has arisen because the economy had to be opened up after long years of separation from international prices. The non-convertibility of renminbi to foreign currencies and the use of an internal rate for trade settlements in the period 1981–84 also reflect the problems China is facing. However the big devaluation of renminbi, the establishment of foreign currency regulation markets, the increase of foreign currency reserves, and the good achievements of foreign trade have decreased the gap between official and black-market exchange rates since the end of the 1980s.

Summary

It will be no mean feat for present-day China to realize its aim of an overall market economy, judging from the problems of determining and utilizing such economic regulators as prices, taxes, and interests. The author discussed the necessity of price reforms after the start of China’s economic reforms in China Newsletter.28 The unreasonableness of the price system is the result of long years of abuse of the economy and cannot be put right overnight. As the Chinese put it, “the three feet of ice under your feet is the result of a lot of cold days in the past.”29 This is all the more true due to the sheet size of the population and land area.

China’s leadership is now facing a double-sided issue of, on the one hand, how to gradually change over from administrative control by central and local government plans to control through economic means and, on the other, how to use economic regulators to guide sectors of the economy no longer under the plans (including black markets). The spread of multiple prices is one problem which has occurred in the transition period from a mandatory planned economy to a market economy. China has indeed taken the first steps toward a market economy, but it still has a long way to go.

Notes

This chapter is based on the author’s “Planning and the Market in China,” Developing Economies, Vol.25, No.4 (December 1987).

1 This system started in the Soviet Union. The theory behind it is the Stalinist theory that means of production circulating among state-owned enterprises are not commodities. In present-day Chinese theoretical understanding, wuzi materials and equipment are also shangpin commodities (Sun Shanqing et al., “Shiping woguo jingji xuejie 30 nianlai guanyu shehuizhuyi shangpin, jiazhi wenti de taolun” [An appraisal of the discussions on socialist commodities and prices by China’s economic circles in the past thirty years], Jingji yanjiu, 1979, No.10, pp.10–11. However, in practice, the term wuzi is still used.

2 In 1980 the classification of wuzi was partially revised into three categories of “planned distribution” (for energy, major materials, and important equipment—government-fixed prices), “purchase and sale by wuzi supply enterprises” (for some machines, metal materials, chemical materials, and construction materials—floating prices), and “sale by producers” (other materials—free market prices).

In 1992 the “planned distribution” wuzi will be divided into three groups. The first group is to be supplied through contracts with the different levels of governments (rubber, tires, wood, cars, cement, etc.). The second group is intended to lessen the range of mandatory planning as the preparatory stage for the transfer over to the contract system with the different levels of governments (rolled steel, nonfer-
ous metals, etc.). The third group will remain under mandatory planning (coal, petroleum, etc.) [Jingji daobao (Hong Kong), 1992, No.48, p.26].


4. Li Kaixin, “Fizhong wuiaozheng zhongdian jianshe” [Concentrate material resources to accomplish important construction], Hongqi, 1983, No.17, pp.16–17.


6. The producer goods supplied under the Shanghai Bureau of Materials and Equipment were subject to the following four regulations (Xu Yi et al., Shehui zhuyi jiajie wenzi [Socialist price problems] [Beijing: Zhongguo-caizheng-jingji-chubanshe, 1982], p.235).

(a) Supply is only possible within the city; supply outside the city is not permitted.

(b) Supply is only possible within the industrial sectors controlled by the respective supervisory organizations; supply across sectoral lines is not permitted.

(c) Supply of materials and equipment under category I and category II to other provinces (cities) is not permitted. Supply of materials and equipment under category III outside of the city is allowed, but letters of introduction are required.

(d) Supply is only possible to state-owned enterprises; supply to collective-owned enterprises is not permitted.


8. China’s wuzi classification does not correspond to the international classification of commodities. For example, lumber, coal, and cement based on China’s classification fall under the intermediate classification of “Divisions” in the Commodity Indexes for the Standard International Trade Classification (SITC), while rolled steel, copper, and other metals fall under the lower level subclassification of “List of Groups” in the SITC.


Inflation and Economic Reform

During the period from May through August 1988, the Chinese top-leadership repeatedly assured all concerned that price and wage reforms would be carried out by all means. But as soon as the price reform policy was announced, urban residents, peasants, and enterprises alike panicked and began hoarding goods. This pushed up inflation to an annual rate of over 20 per cent. Facing this situation, the Third Plenary Session of the 13th Central Committee of the Communist Party of China decided to postpone price reforms indefinitely.

In this chapter I would like to look at the relationship between inflation and economic reform in China. Inflation in China since the commencement of economic reform has resulted from the compounded effects of three factors: demand-pull, cost-push, and money supply.

Price Reform and Inflation

From Repressed Inflation to Open Inflation

The shift to an open economy at the end of 1978 required corresponding economic reforms. In response China adopted a set of measures to decentralize enterprise management and introduce the market mechanism. This generated a sustained upward price trend. Official statistics show that an employee’s cost of living index, which had risen at a meager 1.3 per cent per annum from 1950 through 1978, began to climb at an annual average rate of 6.54 per cent during the 1978–88 period, a figure almost five times higher than during the previous twenty-eight years. This sudden increase in the price index indicates that with the abolition of official price controls, the inflationary potential lurking in the shadows of the old system was let loose and made itself felt in the form of rising prices.

In a socialist planned economy where government-set prices carry dominant weight in the price mechanism, supply-demand gaps do not necessarily express themselves in the form of price increases for goods in short supply. The presence of such a gap, therefore, does not necessarily lead to a rise in the price index statistics.

Instead, the gap asserts itself in one or more of the following forms: (1) the inevitability of goods rationing systems characterized by the familiar scenes of consumers queuing up in front of shops, (2) a widening gap between the official and market prices, (3) forced savings, and (4) a rampancy of black markets, corruption, and special treatment for the privileged. Thus vegetables, for example, tend to disappear from state-run stores in the winter time. The cheap-price-tags-but-no-goods phenomenon is also a way in which the supply-demand gap in socialist countries expresses itself. This factor we will call repressed inflation, which certainly existed in China during the period before 1978.

Regarding the credibility of the Chinese price index, I have discussed the Chinese method of price indexing in an earlier paper entitled “The Price Problem and Economic Reform.” My conclusion was that there is no reason why current Chinese price statistics should be considered untrustworthy any more than the price statistics of other countries. However, it is in fact true that past Chinese statistics have had some accuracy problems.

The temptation has been great in socialist countries to perform some artificial operations with price statistics to make their inflation rates look lower than they actually are. In addition to attempts to demonstrate stable prices with such operations, they can inflate real output growth rates by underestimating rates of price increases. In calculating the price index, all the former socialist countries except the former Czechoslovakia, Poland, and the former Yugoslavia followed the Paasche formula which is based on comparable period fixed weight.

By contrast, most capitalist countries use the Laspeyres formula which is based on base-period fixed weight. Aside from the question of which formula is the better indicator of the true price level, the index produced by the Paasche formula is certainly lower than that produced by the Laspeyres formula, given that the consumer’s utility function remains the same.

According to Alec Nove, “when Soviet statisticians calculate a cost of living index, they are careful to use end year weights, which minimize the increase in prices and so represent real wages in a more favourable light.” China too has stated that it theoretically follows the Paasche formula. Supposing that there is a concealed differential between the official figure of the price index and the real one, that inflationary figure should also be considered in examining the Chinese price index (see Figure 3-1.)
The Abolition of Price Controls

Since 1979, the year in which economic reforms were initiated, price control measures have been removed one after another. Consequently, the market share of the goods sold at government-determined prices has remarkably diminished. Between the pre-reform year of 1978 and the mid-reform year of 1986, the rate of agricultural products transacted at government-determined prices declined from 92.6 per cent to 37 per cent, that for major producer goods fell from 100 per cent to 64 per cent, and that for industrially manufactured consumer products went from 97 per cent to 45 per cent (see Table 3-1). In Guangdong and Jiangsu the conversion to market prices is proceeding more quickly.

In addition to the abolition of price controls, price reform involved two more aspects: government adjustment of relative commodity prices and the decentralization of pricing decision powers. Price reform was aimed at creating rational relative prices among different commodities by introducing, or at least partially employing, the market mechanism. The reform in itself would not necessarily lead to price increases.

In reality, however, it was difficult to reduce the prices of overvalued commodities, since such action would go against the interests of the enterprises and government agencies involved. Consequently, adjustment was done only by rais-
Inflation and Economic Reform

...the workers at enterprises with large retained profits obtain large bonuses, while only 20 per cent is set aside for non-productive investment, increasing allowances of various kinds, and non-productive investment, which the enterprises concerned wield in their negotiations with the government agencies concerned. The underpaid workers thus feel they have the right to demand the same amount of wages and bonuses as those working at enterprises with larger retained profits.

The second factor is the changing role of the factory director. Under the traditional system, the factory director used to represent the government itself, or the government agency in charge of the factory. Economic reform attempts to change this system so that the director becomes a new type of manager representing the interests of his factory. But at the moment the main concern of the factory director is how he can best meet the demands of his employees and promote his interests. He is least interested in investment for long-term goals. This is so because his evaluation during his term of appointment is based on how the employees evaluate him; thus it is important for him to create favorable personal connections in order to make his job easier during his appointment and to facilitate his career after the expiration of his term of office. For these reasons around 80 per cent of the retained profit an average is appropriated for bonuses and intra-enterprise welfare, while only 20 per cent is set aside for productive purposes.

The third factor is the so-called unit-ism (danwei zhuyi) on which all Chinese enterprises are based. The Chinese state-owned enterprise is not merely a workplace; it is the total arena of life for its employees, providing them with restaurants, apartment houses, and cultural or recreational facilities as well as labor insurance, health insurance, and pensions. These facilities are provided free or very inexpensively. With this protection, urban residents employed by these enterprises tend to concentrate their cash spending on the purchase of food, clothing, and other articles for daily consumption. This is one reason why the prices of daily necessities tend to rise so easily.

Under this enterprise system, the portion of retained profit ultimately appropriated for consumption tends to grow rapidly. It rises in the form of bonuses, increasing allowances of various kinds, and non-productive investment, mainly housing construction. From 1981 through 1986 the basic wage per state-owned enterprise employee grew by an annual average of 17.5 per cent, while bonuses and allowances paid out of retained profits kept growing at an annual rate of 25.7 per cent. Meanwhile, the share of non-productive investment by these enterprises out of total fixed asset investment ranged between 40.3 per cent and 45.5 per cent during the 1981-85 period. Housing investment alone accounted for 18.2 to 25.4 per cent during the same period. On the other hand, during the 1953-80 period, non-productive investment accounted for 14.6-33 per cent, with housing investment accounting for 4 to 11.8 per cent. Obviously non-productive investment has made a quantum leap since the introduction of the economic reform program.

The most remarkable growth can be seen in the so-called collective consumption by units. This means the use of official money for official purposes by government agencies, party organizations, and other social bodies, as well as...
Personal consumption also remained vigorous. High- and medium-grade goods, once only objects of collective consumption, have now begun to be bought by individuals. Falling in this category are pianos, Chinese and English books, newspapers, magazines, electrical appliances, cars, kitchen equipment, calculators, pharmaceuticals, general work safety equipment, as well as medical services, labor insurance, banquet services, and recreational tours and outings for employees.

Even though consumption restrictions were attempted in order to remedy economic overheating, still collective consumption in 1987 amounted to 55,300 million yuan, up 19.6 per cent from the previous year. It is also well known that the actual collective consumption figure is always larger than official statistics suggest.

In 1981 workplace units all over the country collectively consumed 15,728 vehicle requires 10,000 yuan a year in driving and maintenance costs, the expenditure increment in the ten years since 1986 comes to a staggering 30 billion yuan, which is equal to 13.4 per cent of the central and local governments' revenue in 1986. Furthermore, the construction of lou, tang, guan, suo ("office buildings, assembly halls, hotels, and guest houses") has increased at a rapid pace, and this has necessitated the collective consumption of furniture and electrical appliances. For example, the purchase in this category of video recorders rose thirty-two times and that of sofas twenty-one times between 1981 and 1986. Collective consumption of air conditioning equipment, color TV sets, and carpeting also grew two to three times during the same period.

Personal consumption also remained vigorous. High- and medium-grade goods, once only objects of collective consumption, have now begun to be bought by individuals. Falling in this category are pianos, Chinese and English typewriters, high-grade cameras, and electronic organs. Wedding costs in urban centers are also skyrocketing. A survey in Liaoning Province in 1986 showed the average wedding costing as high as 7,000 yuan. Given the 400,000 weddings held per year in this province, the total cost of these ceremonies comes to a surprising one quarter of the total wages paid in the province.

The fourth and final factor is the increase in demand for agricultural products and daily necessities due to the increase in the population leaving agricultural production in the rural districts. However, this was not a major or direct factor causing the inflation of the 1980s because of the following reasons:

1. The influx of population from rural to urban areas has not increased so much. Based on a survey, peasants transferring from agriculture to other industries in the period of 1979–88 numbered 66.5 million, but among them only 17.9 per cent moved into urban districts. But most of them have not left the rural districts, and many of the newly employed workers still do agricultural work on a part-time basis. Moreover, judging from the absolute number of laborers, there have been no decrease in the number of workers engaged in the primary sector.

2. Comparing the relative prices, there was no noticeable rise in the prices of agricultural products. This was partly because most of the price subsidies were used to suppress the retail prices of agricultural products. Though the burgeoning fiscal deficit was caused in part by the price subsidies, a more important reason should be attributed to the below--mentioned money-supply factor of inflation.

Even making allowance for these characteristic conditions of China, the massive movement of population from rural to urban areas is historically inevitable. In the future it will certainly create a huge additional group of people who will consume commercialized agricultural products.
The Cost-push Factor

Multiple pricing in China has developed along two lines. First, the pricing bifurcated into government-controlled and enterprise-determined sales prices. Enterprises under central government control can sell surplus products exceeding the government quota at the government-guided and/or the market-adjusted price. Second, price has been ramified in accordance with the diversified systems of ownership, ranging from central state-owned, through local government-owned, to collective-owned and privately owned. The pluralization of ownership under economic reform has gone hand in hand with multiple pricing.

Insofar as it developed along with the progress in economic and price reforms, multiple pricing has played a positive role. Li Baoshi and others argued that multiple pricing has had the following positive aspects.16

First, China at the present time is not prepared to shift fully from a government-determined price system to a market-adjusted price system. The multiple price system is a proper choice in view of the central government’s limited fiscal capacity, the low degree of development of a market economy, and the poor ability of enterprises to absorb cost increases. Under this system, the margin of price fluctuations is relatively small, so both the buyer and seller can accept them. Second, the fluctuations of market-adjusted prices can be used as a referent in determining government-determined prices. Third, enterprises can increase their revenues by selling their surplus products at self-determined prices. Fourth, this system encourages the manufacturing enterprise to absorb raw-material price increases through production cost reduction. Fifth, the share of goods distributed by the central government as well as the importance of government-determined pricing will decrease with the spread of multiple pricing.

On the other hand, the same Chinese scholars point to negative aspects of this system. First, the enterprises producing producer goods will endeavor to increase the portion of their output that is marketable at higher prices. Thus, in many cases they will be tempted to sell products at self-determined prices without fulfilling government-imposed production targets. Second, market-adjusted prices under the multiple pricing system do not accurately reflect the actual supply-demand situation. The market-adjusted price subject to this system tends to be higher than if it were subject to a total market mechanism. The market seems to be tighter than is justified by the real supply-demand situation. The dual presence of government prices and market prices thus distorts both of them.17 Also, goods in short supply can often serve as hard currency exchangeable with any other goods. Third, it is possible under this system to buy cheap and sell dear. Therefore, it spurs speculation, selling short, and other irregular economic practice.

The multiple price system thus has both positive and negative aspects. While serving as an incentive to enterprises to increase production, this system also tends to trigger price hikes in both legal and illegal forms. The most serious illegal price hiking involves producer goods. In fact, most of the cases of illegal price hikes which produce revenues of 10,000 yuan or more are carried out by enterprises selling, buying, or producing producer goods.18 In May 1987 the State Council had to issue a decree to strengthen price controls on producer goods and prohibit arbitrary increases in their prices.19

Multiple pricing, together with consequent legally and illegally conducted price hikes, has brought about a general rise in producer-goods prices. Under the existing Chinese system, such rises inevitably lead to cost-push inflation for the following reasons.20

First, economic reforms centering on retained profits as their chief incentive, combined with the contract management responsibility system, has the effect of making enterprise behavior myopic. Under the pre-reform system, there was no link between business performance and the wage and welfare level of employees. The enterprise paid no attention to its cost/price ratio, and cost increases did not necessarily lead to rises in product prices. By contrast, under the reformed system, the enterprise has to show good result during the contract period. Thus motivated, the enterprise pursues short-term profits, even though it knows such behavior would undermine its long-term interests by causing its market share to diminish and its product competitiveness to decline. Cost increases under these circumstances would be shifted onto product prices rather than absorbed by rationalization. According to Zhang Zhuyuan,21 enterprises generally shifted 70 per cent of the material and energy cost increments onto product prices. And according to Zhang and Yang,22 90 per cent of the material cost increment is shifted onto the product prices.

Second, there are abundant opportunities to raise prices in an economy of scarcity. Given the seller’s market, cost increments are easily translated into higher prices.

Third, the reforms have stressed decentralization, giving enterprises larger decision-making powers, but have not duly taken measures to let the market and price mechanism function normally. The transfer of price determination to individual enterprises would not necessarily cause price increases as long as the market operates in a competitive environment. But in the absence of a proper market mechanism, cost increases are very easily shifted to prices. This is especially so in present-day China where most state-owned enterprises are monopoly or oligopoly enterprises.

The Money Supply Factor

Analysis of the relationship between the price index and money supply depends largely on which indicator one takes as representative of the money supply. First, let us use cash flow excluding money on deposit (M0).

The following inter-relationship is identified from M0 fluctuations shown in the monetary survey table.23
The factors that chiefly influence $M_0$ fluctuations are net increases in loans to the government and non-government bodies. Table 3-4 indicates changes over time of the net increase in loans to the government, the rate of increase in loans to non-government bodies, the rate of increase in money now in circulation, and the consumer price index (the employee's cost of living index), which are shown in Figure 3-2.

$M_0$ increase = (increase in loans to government) + (increase in foreign exchange holdings) + (increase in non-government bodies - deposit increase) + (increase in fiscal appropriative deposits) - others.

Note: The rate of increase of cash in circulation dropped markedly in 1990 due to austerity measures under the adjustment policy and the loss of consumer demand.


In 1985 the fiscally appropriative deposits increased drastically, while loans to the government did not. Consequently the net increase in loans to the government became minus 18,822 million yuan, which theoretically would drastically push down $M_0$.

But the $M_0$ rate of increase stayed as high as 24.7 per cent that year (no significant drop from the previous year) because loans to non-governmental bodies were dramatically expanded. $M_0$ again attained a high rate of increase, 46.7 per cent, in 1988. This was due to a failure to suppress loans to non-governmental bodies, as well as a massive withdrawal of private deposits.

Money in circulation, or $M_0$, is spent mainly for the purchase of consumer goods. As Figure 3-3 indicates, 70 per cent of the cash in circulation is used for commodity purchases. Unless consumer goods supply is increased in proportion to $M_0$ increase, a supply-demand gap will result and create inflationary pressure.

Minoru Nambu has obtained a "total inflation index" using a formula presented by K.H. Hsiao. The formula is fundamentally the ratio of money in circulation to the commodity retail value:24

$$I_t = \frac{I_m}{I_r}$$

where $I_t$ = total inflation index, $I_m$ = index for money in circulation, $I_r$ = index for aggregate retail sales of social commodities in the current price of the year concerned, and $I_p$ = total index for commodity retail price.

Using this formula, the total inflation index in 1988 (base year 1978 = 100) was 364.2 (Table 3-5). The annual average inflation rate from 1979 to 1988 was 13.8 per cent. The official Chinese statistics, however, give 5.6 per cent as the annual rate for total index for commodity retail prices.

Even in China, money supply calculation done merely on the basis of cash in circulation is inappropriate, since it conceals the size of credit created. In fact most settlements between state-owned enterprises are done through transfers between bank accounts. This being the case, the state-owned enterprises and government agencies hold under their control only 20 billion yuan out of the 120 billion in circulation.25

There are also other money supply studies which take into consideration $M_2$, which includes cash and time deposits.26 According to these studies, $K$, which corresponds to Marshall's $K$ in a market economy, can be obtained by calculating the monetized portion of the economy:

$$K = \frac{M_2}{(Y \cdot P \cdot H)}.$$
The Inconsistency of Economic Reform and the Resulting Inflation

The Contract Management Responsibility System

Faced by inflation, the Chinese government called off reforms originally scheduled for 1986 which would revise producer goods prices across the board. Even though this aspect of reform, which was intended to create equally competitive conditions for all enterprises, was abandoned, the other aspects of power decentralization in favor of enterprises were carried on. But since external conditions remained unequal for enterprises, the decision-making powers endowed upon them still had to be subject to control by the government. In delegating such power to enterprises, the government had to take into consideration each enterprise’s business conditions and its business environment. Therefore, the so-called contract management responsibility system was introduced in 1987 and swiftly became the general practice among large and medium-sized state-owned enterprises.

By the end of 1987, of the 12,398 large and medium-sized state-owned enterprises existing in China, 9,270, or approximately three quarters, came under one of the following versions of this system. (1) Contract system for increasing profit quotas to be turned over to the government, under which the enterprise assures the government agency in charge that there will be yearly increases in profit quotas to be received by the agency. This system has been applied to the Capital Iron and Steel Company and 988 other enterprises (8 per cent). (2) Contract system for total wage bill, under which wage bills fluctuate in accordance with profits earned; applied to 1,508 enterprises (12.2 per cent). (3) Contract system for definite amounts of losses or decreasing losses, under which enterprises chronically generating losses guarantee that the annual losses be held below a definite ceiling; applied to 523 enterprises (4.2 per cent). (4) Other various forms of contract management responsibility systems, under which retained profits shall increase if the contract norm of the taxes and profits turned over to the state is over-fulfilled, and the enterprise itself meets any loss from failure to fulfill the norm; applied to 6,250 enterprises (50.4 per cent).

Under all of these systems, a precise and concrete norm is set for each enterprise in accordance with its business performance and product price levels. In setting the norm the government agency in charge and the enterprise concerned engage in serious bargaining. The enterprise’s management proves their political abilities by beating down the norm in negotiations with the government. Therefore, the actual amount of profit retained depends more on this bargaining process than on the enterprise’s performance. Enterprises suffering from chronic losses sign contracts to cut losses by a certain amount. If successful in cutting losses to the contracted level, the enterprises can retain that portion of the revenue, even if it is still in the red overall.

Thus, profitable and non-profitable enterprises alike can expect to increase retained profits under this system, and their employees can expect to obtain wage increases or bonuses out of the retained earnings. Nor do government agencies concerned lose their sense of usefulness under this system, since they feel it is their task to successfully bargain with enterprises and negotiate with the Ministry of Finance and its affiliated agencies.

The government agencies still keep their enterprises under control and supervision. The Ministry of Finance and its affiliated agencies also feel secure, since they can expect stable annual revenue increases. None of four parties involved risks the danger of totally losing its powers though none is fully satisfied with the powers or profits it does enjoy. This system is a product of compromise and so should be acceptable to all.

What then is the relationship between this system and cost-push inflation? I have already argued that the rising producer goods prices induced by price revisions and the abolition of controlled prices has spurred inflation from the cost side. The existing contract management responsibility system demands that enterprise management show better achievement over a short one-year contract term. Management naturally is encouraged to pursue immediate profit increases rather than securing for the enterprise a stable market share over the long-term perspective.

Consequently, the enterprises producing or otherwise handling producer goods, taking advantage of their monopoly or oligopoly positions, tend to raise the sales prices of their products. Under the current multiple pricing system, they have abundant opportunities, both legal and illegal, to sell their goods at prices higher than the government has set. In this sense, the contract management responsibility system contributes to inflation by generating both demand-pull and cost-push pressures.

Expanded Bank Loans

The traditional factor contributing to increase in the money supply is fiscal deficit financing. But the Chinese national budget, which suffered from deficits of 4 billion yuan in 1983 and 1984, chalked up a surplus of 2.160 million yuan in 1985. In spite of this fiscal improvement, the money supply (M2) still increased 24.7 per cent that year, a fairly high figure even if lower than 1984’s 49.5 per cent. As shown in Table 3-4 and Figure 3-2, this was because net bank loan increases, i.e., the difference between bank loans and deposits, soared by 141.4
The shift of investment emphasis from fiscal outlays to bank loans means a shift from non-redeemable grants to redeemable interest-bearing loans. This certainly should raise the operational efficiency of funds, and in fact this was what fiscal and financial reforms were aimed at. But contrary to expectations, what happened was that the explosion of bank loans induced inflation. Why the reform went amiss, and why bank loans were inflated limitless causing investment overheating are questions that need to be answered.

In a market economy like Japan's, financial policies as means of controlling the macro-economy follow two methods: one of qualitative control and the other of quantitative adjustment (Figure 3-4). In China's case, the process of implementing fiscal and financial measures shifted emphasis from a qualitative control to a direct-control (window-control) method. At the present stage of development in Chinese financial management, where financial markets are just being organized, interest policies as means of control have definite limitations. Nor are the conditions ripe for the effective functioning of orthodox financial adjustment measures centering on open market operations and changes in reserve ratio.

The basic cause for the credit explosion in China may be sought in the fact that the role of traditional qualitative control was weakened before quantitative control measures, which theoretically were to replace qualitative control, could function effectively.

Table 3-7 shows the results of a survey on the causes for uncollectible loans
financed by local branches of two banks. We can conclude from this table that local bank branches, bound by strong ties with the local party and administrative organizations, extended loans to fulfill guidelines (more or less arbitrary directives) by the local party organizations or local government agencies or else in consideration of the effects of loans on the local economy or local government finances, even when chances of recovering them were doubtful.

There may be several reasons why local bank branches attach more importance to local government guidelines than to the policy of their head-offices. The major reason is that the local government has the right to appoint or dismiss personnel at local bank branches. Since 1976 local bank branches have been subject to dual control—control exercised both by their head-_offices and by the provincial, municipal, and/or autonomous district governments, with the local governments having a stronger say in the running of day-to-day bank business. Under this dual system, affairs pertaining to personnel, including the right to appoint, transfer, and dismiss bank staff, were transferred to the local government. Fearing reprisals, local bank leaders by and large do not dare use their discretion over loans, even if the local government policy contravenes the central government’s fiscal and economic guidelines. Furthermore, the powers of the bank head-offices are being reduced more and more within the current institutional reforms. Traditionally, the head-office controlled all deposits and all loans at the branch level, but now it checks only deposit/loan balances.

There are other ties between local banks and local governments. Normally an enterprise having drawn a loan from a bank has to repay it with interest. However, a preferential tax measure is in force which allows loan repayment funds to be deducted from the enterprise’s income tax, if the local government so authorizes. Whether the borrowing enterprise can avail itself of this preferential treatment or not often decides the enterprise’s ability to pay back the loan. Therefore this obviously is a serious concern of the bank in question.
In conclusion, Chinese economic reform will for the time being have to see-
saw back and forth through a process of trial and error overcoming obstacles
and easing contradictions as they emerge. A transitional period where old and
new systems coexist will probably last for quite a long period of time before
new reform measures can be systematized and institutionalized, and thus begin
to fully function.

Notes
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3 He Dao feng et al., “Lun woguo jinnian tonghuo pengzhang de fasheng jizhi yu jie-
gou de biaoxian” [The causative mechanism and the construction in China’s infla-
tion], Jingji yanjiu, 1987, No.11, p.27.
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21 Zhang Zhuyuan, “Woguò wújiā shangzhǎng de yuānyíng yu duǐce” [The cause of
China’s inflation and the counter plan], Guāngmíng ribao, April 23, 1988.
22 Zhang Shuguang and Yang Zhongwei, “Woguò tōnghuo pengzhāng de xiāoyíng fènxí”
Reorientation of Economic Reform and Medium- and Long-term Perspectives

Introduction

As was explained in Chapter 1, the Chinese economic reform and its goals were conditioned by new economic developments that had the momentum of breaking up the old institutional framework. The reform was composed of two major factors—expansion of decision-making powers for enterprises and local governments on the one hand and introduction of the market mechanism on the other hand.

In this chapter, I examine how economic reform has evolved, and, in particular, how the reform shifted from an acceleration phase to an adjustment phase. I will then look into the mechanism that generated irregular behavior by state-owned enterprises when the reform came to a standstill. Lastly, I will examine the medium- and long-term perspectives of economic reform and discuss what market economy model China is hoping to adopt.

The Trajectory of Economic Reform

Three Stages of Reform

Around the end of 1978 when the Third Plenary Session of the 11th Central Committee of the Communist Party of China was held, China began making efforts to depart from the Mao Zedong system by adopting economic reform and an open-door policy. More than a decade has passed since China began to implement this policy. During this time, the Chinese government has carried out a number of decrees and laws for reform, and new reform measures have
also been taken by enterprises and local governments. The main measures taken in this direction are chronologically shown in Table 4-1. Economic reform until 1988 can be broadly divided into the following three stages.

The first stage (December 1978—October 1984)

The emphasis of reform during this period was on rural areas. People’s communes maintained over the previous two decades were dissolved and divided into administrative organizations (xiang or township) and economic organizations (production teams and rural industrial enterprises). The collective management of production teams was replaced by household management of production. The latter form of management spread to more than 90 per cent of the farming households by the end of 1983.

Reform measures were taken in urban areas, too, mainly to transfer powers formerly in the hands of the central government to enterprises and local governments. Chief among these measures was the introduction in February 1980 of the profit-retention system for enterprises and the contract system for fiscal revenue and expenditure between central and local governments. In some major cities, integrated reform measures were experimented with the areas within their jurisdictions.

The second stage (October 1984—October 1987)

The reform entered its second stage following the Third Plenary Session of the 12th Central Committee of the Communist Party of China held in October 1984. This meeting adopted the “Decision of the Central Committee of the Communist Party of China on reforming the economic system” which characterized the future economic system of China as “a planned commodity economy under public ownership.” What this meant in real terms was:

(a) the further development of a commodity economy under socialism meaning a planned “commodity economy” and not a “market economy” reliant exclusively on market regulation;

(b) however, some agricultural and subsidiary products, daily sundry goods and services would be left to market regulation free from the control of planning. Market regulation thus would play an auxiliary role in the national economy;

(c) the planned economy would be subject to both “mandatory planning” (based on administrative decrees) and “guidance planning” (based on inducements and other non-mandatory measures); and

(d) the scope of mandatory planning would be gradually reduced and that of guidance planning gradually expanded.

This decision unambiguously provided for a set of policies conducive to the development of a commodity economy under socialism and would accelerate marketization of the economy, but with the proviso that this would not mean introduction of a total “market economy” dependent on market regulation. In

| January 1981 | Many agreements for the import of plants from Western countries were canceled. |
| October 1981 | The national working conference on the rural districts, uplifting the variety of responsibility systems for production. |
| April 1982 | The dismantling of the People’s Communes (separating the administrative unit and the economic organization) is incorporated into the Constitution. |
| May 1984 | The open-door policy is applied to seventeen coastal cities and Hainan island. |
| Aug. 1984 | Provisional regulations on further extending the decision-making power of the state industrial enterprises. |
| Aug. 1985 | The regulation concerning the improvement of the planning system. |
| Dec. 1985 | Abandonment of the policy of state monopoly for the purchase of grain and adopting the policy of purchase by order. |
| Oct. 1987 | The open-door policy is extended to Shandong Peninsula and Liaodong Peninsula. |

TABLE 4-1

<table>
<thead>
<tr>
<th>Policies and Measures on Economic Reform and the Open Door</th>
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<tr>
<td>The first period of reform and open-door policy</td>
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<tr>
<td>1978 Dec. The Third Plenary Session of the 11th Central Committee of the Communist Party of China; the adoption of an open-door policy</td>
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<td>1979 June The Second Session of the 5th National People’s Congress; the adoption of an open-door policy</td>
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<td>1980 July Five documents on the reform of the management system in state-owned industrial enterprise.</td>
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<td>1980 July The Law of the People’s Republic of China on Chinese-Foreign Joint Ventures</td>
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<tr>
<td>1980 Feb. Reform of the fiscal system, setting down the resources of revenue for the central and local governments.</td>
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<tr>
<td>1981 Jan. Many agreements for the import of plants from Western countries were canceled.</td>
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<tr>
<td>1981 Oct. The national working conference on the rural districts, uplifting the variety of responsibility systems for production.</td>
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<tr>
<td>1982 May The abolition of state-determined prices for meat, fish, eggs, vegetables, and fruits. (At the end of 1985 the state-controlled prices for these items were reintroduced)</td>
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<tr>
<td>1983 May The State Commission for Restructuring the Economic System is established (the presiding minister is Zhao Ziyang).</td>
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<tr>
<td>1984 Apr. The open-door policy is applied to fourteen coastal cities and Hainan island.</td>
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<td>1984 May Provisional regulations on further extending the decision-making power of the state industrial enterprises.</td>
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<td>1984 Aug. The regulation concerning the improvement of the planning system.</td>
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<td>The second period of reform and open-door policy</td>
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<td>1984 Oct. The Third Plenary Session of the 12th Central Committee of the Communist Party of China; the decision on reforming the economic system.</td>
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<td>1985 Jan. Abandonment of the policy of state monopoly for the purchase of grain and adopting the policy of purchase by order.</td>
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<td>1985 Feb. The open-door policy is applied to three delta zones.</td>
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<tr>
<td>1985 May The abolition of state-determined prices for meat, fish, eggs, vegetables, and fruits. (At the end of 1985 the state-controlled prices for these items were reintroduced)</td>
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<tr>
<td>1985 Sept. The regulation concerning the energizing of state-owned large and medium-sized enterprises.</td>
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<td>1986 Mar. The regulation concerning the acceleration of horizontal economic combinations between enterprises.</td>
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<tr>
<td>1987 Apr. The law on enterprises owned by foreign capitalists.</td>
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<tr>
<td>1987 Aug. The abolition of state-determined prices for monochrome television sets, refrigerators, washing machines, and others.</td>
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<tr>
<td>1987 Sept. Adoption of the contract system for employing new laborers, and promulgating regulations concerning the dismissal of employees and unemployment insurance.</td>
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<tr>
<td>1987 Oct. Three regulations concerning the management of state-owned enterprises, including the regulation on the systems of factory director’s responsibility.</td>
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<tr>
<td>1987 Oct. The open-door policy is extended to Shandong Peninsula and Liaodong Peninsula.</td>
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The decision marked a definite departure from the traditional socialist model. Since that decision, economic reform has shifted emphasis from rural to urban areas. Waves of reform policies began to spread to micro- and macro-levels directed at the main systems including planning, production, distribution, finances, prices, labor, wages, trade and so on. In rural areas, the compulsory procurement system of agricultural products was replaced by the system of purchases through markets. Central to this change was the replacement of the state monopoly for purchases of grain with a system of contracted purchases on order of the state.

### The third period of reform and open-door policy

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<td>1987</td>
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### The adjustment policy

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<td>1988</td>
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<td>1990</td>
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<td>1991</td>
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### The fourth period of reform and open-door policy

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<td>1992</td>
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### The third stage (October 1987–September 1988)

In his report to the 13th National Congress of the Communist Party of China held in the autumn of 1987, Zhao Ziyang hammered out a clear policy of further stepping up the reform and open-door line. According to Zhao’s report, China was at a historical stage defined as the primary stage of socialism. This has a dual meaning: on the one hand China is still a socialist society based on public ownership of means of production, but on the other hand, given the low level of productive forces and immaturity of commodity economy, China will require a long time, at least the period to the year 2050, to achieve industrialization and modernization.

Having thus defined the historical stage China was at, Zhao proposed the following six points as essential to the economic reform:

1. State-owned enterprise activities should be energized through the separation of management from ownership. For this, independent accounting of enterprises, the system of factory director’s responsibility, and management responsibility should be promoted. Also, the joint stock system should be recognized as a form of asset management of socialist enterprises and continue to be experimented with.

2. Horizontal economic combination among enterprises should be developed beyond administrative barriers. Large and medium-sized enterprises producing quality goods should be the cores of economic combination. Enterprise groups should pursue advantages of specialization and economies of scale. Also, the economic zones played a leading role by cities should be encouraged to be formed.

3. The temper for fostering socialist market systems should quicken. Markets should be formed not only for production and consumption goods but also for capital, services, technologies, information, and real estates.

4. The financial and fiscal systems should be reformed to strengthen leverage to control macro economy.

5. While retaining the state and collective ownership systems as the core, other forms of ownership should also be developed, including hezuo jingji (cooperatives paying dividends in accordance with investment shares), sying qiye (private enterprises employing many wage workers), and self-employed businesses.

6. While keeping distribution in accordance with labor as the basis, other distribution systems should also be carried out. Thus legalized were interest revenues, stock dividends, and “unearned incomes” accruing to private enterprise owners.

The most important point of Zhao’s report was his definition of the primary stage of socialism which legalized the presence of private enterprise and justified stock dividends and profits earned by private entrepreneurs. Whether such diversity in ownership should be tolerated only at the primary stage of social-
ism or should be accepted at further stages was still being debated. Dong Fureng, then director of the Institute of Economics under the Chinese Academy of Social Sciences, argued that diversity in ownership should exist even after the primary stage. The 13th Congress report also raised the issue of political reform, and proposed a series of reforms in order to do away with negative aspects of excessive concentration of power, bureaucratism, and remnants of feudalism.

The Seventh People's Congress held in the spring of 1988 adopted the law concerning state-owned industrial enterprises and sent into force the law for the bankruptcy of state-owned enterprises. Also illuminated was the strategy for the development of coastal districts. This encouraged foreign firms to invest in these districts.

Shift to Adjustment Policies (September 1988–December 1991)

In 1988 China achieved high growth rates, 11.0 per cent in GNP growth and 20.8 per cent in mining and manufacturing growth. In the meantime, the consumer price index soared 20.7 per cent and the major producer-goods sales price index 21.5 per cent. Inflation galloped. That year, the national policy also had to change. In the first half of the year the reform and open-door package was promoted but in the second half the policy had to be switched to one of austerity and adjustment.

After the price freeze period of the 1988 Spring Festival was over, the prices of industrial products for daily use were raised one after another in Shanghai, Nanjing, Wuhan, and Beijing. In May a rise in prices of non-staple food was announced in urban districts. The prices of pork, beef, eggs, refined sugar, and vegetables jumped 30–60 per cent in Beijing. Postal fees and taxi fares were raised in June and cigarette and alcoholic drinks prices followed in July.

From May through July, Deng Xiaoping, Zhao Ziyang, and other top leaders made the point on all available occasions that the price and wage system reforms should be carried out by all means. The August meeting of the Central Committee's Political Bureau adopted "the primary program concerning price reform and wage reform."

Such statements by the leadership and the rush for price-hikes caused social unrest. Toward the end of August citizens and farmers rushed to shops for hoarding. Banks had a run. The Industrial and Commercial Bank of China lost personal deposits by 2.3 billion yuan in the single month of August.

As the public was seized with a panic, the leadership toned down their reform and open-door pronouncements. The Executive Meeting of the State Council held at the end of August adopted an urgent decision on price policy and market stability, postponing price reform. The Third Plenary Session of the 13th Central Committee of the Communist Party of China held at the end of September decided to shift the emphasis of economic management in the two following years onto "the improvement of the economic environment and rectification of the economic order." This marked China's shift to adjustment. Though austerity and adjustment policies had been temporarily enforced in 1981 and 1986, the adjustment this time turned out far more drastic, causing industrial output and sales to drop the most sharply ever.

After the suppression by the army of the Tian'anmen demonstration in June 1989, the austerity program was further stepped up. The term of adjustment was elongated from the originally planned two years to three years (1989–91) or more. Prime Minister Li Peng proposed three major adjustment policies at the Plenary Session of the State Council held in August.

The first is that the emphasis of the price policy should be on stability of the prices of daily necessities for consumption by medium- and lower-income groups. The second is that much more efforts should be made to ensure enough supply of producer goods for agriculture and to make available enough funds for the purchase of agricultural products so as to help farmers achieve good harvest. The third is that investment in fixed capital formation should be reduced in order to suppress gross demand. Wages and collective consumption by units should be held low. Taxation should be strengthened in order to rectify unfair distribution.

The adjustment policy has been partially successful in the suppressing of inflation, mostly owing to the sudden decline of demand for consumption goods caused by the Tian-anmen incident. However, a look at economic management as a whole shows that the serious problems have not been resolved. According to the report of the fourth session of the National People's Congress by Zou Jiahua, Minister of the State Planning Commission, the difficulties facing the Chinese economy are comprised of the following components.

First, many state-owned industries, in particular the large and medium-sized enterprises, have fallen into deficit. Second, the economic cycle remains abnormal, in the process of industrial production recovery, some products have been selling poorly while inventories have been growing, obstructing the normal cycle in the economy as a whole. Third, no progress has been made in the adjustment of the economic structure and economic efficiency has actually dropped. Fourth, the fiscal deficit has swelled.

In March 1990, the course of the retrenchment program was altered and the economy gradually turned towards recovery. At last even Prime Minister Li Peng was obliged to declare an end to the adjustment policy in September 1991.

Achievements in Enterprise Reform

The Three Aspects of Enterprise Reform

China's enterprise reform program has involved three aspects—reforming the relationship between the government and enterprises, reforming the relationship between enterprises, and reforming intra-enterprise relationships.
Regarding the first, the reforms intended to reduce to a minimum government regulation and control over enterprises, the purpose being to give them discretionary powers over production, marketing, and investment. In 1988 “The law concerning state-owned industrial enterprises,” “The law for the bankruptcy of state-owned enterprises,” “Regulations on the contract management responsibility system,” and “Regulations on the lease management of state-owned enterprises” were enacted to facilitate enterprise reform.

The contract management responsibility system is now applied to most of the state-owned enterprises. This system represents a less radical reform than a corporate income tax system that was the objective to be accomplished in the mid-eighties. It does however represent a new approach compared with the pre-1978 enterprise system, and the contract system introduced a new mechanism into Chinese enterprise management.6

Under this system, for instance, the principle of competition began to function, even if only partially, in Chinese enterprises. In 1988, 35.5 per cent of state-owned enterprises contracted for quotas through competitive bidding. In cases where the contracted quotas are not fulfilled, the system calls for the risk to be borne by the top manager, by management as a whole, or by the employees as a collective. This risk-taking system is currently applied to 25 per cent of the Chinese state-owned enterprises.

Regarding reform in inter-enterprise relationships, enterprise mergers have been encouraged. A total of 2,856 enterprises absorbed 3,424 other enterprises in twenty-seven provinces and municipalities. Aside from such enterprise mergers, partnerships and tie-ups are being promoted among enterprises which are compatible in technology, production, and marketing. By the end of 1988, 1,362 enterprise complexes were thus established in eighteen provinces and municipalities. Of them more than 100 are large complexes.

Reform measures have also been taken on a trial basis in intra-enterprise relations. The system of giving responsibility to the factory director was being applied in 95 per cent of the state industrial and commercial enterprises by the end of 1988.

Employee wages have also been linked with the quota system whereby wages are determined by the extent that contracted quotas (norms) are achieved. Quotas (norms) are set in accordance with various factors specific to each enterprise. The kinds of quotas linked with total wage are the profits earned, profits turned in to the state, taxes, output, sales, work volume, and foreign exchange earnings. The system of determining the total wage in this manner was introduced into more than half of the state-owned enterprises by the end of 1988.

Reform in the employment system was also introduced on a full scale in the autumn of 1988. New workers are thus no longer hired as life-time employees but are hired on a contract basis. The number of contract workers in 1988 reached 9,920,000 persons, or 10 per cent of all state-owned enterprise employees.

Labor-force rationalization was also launched. Thirteen million employees at thirty thousand of the state-owned enterprises, 13 per cent of all state-owned enterprise employees, were transferred to new positions or otherwise reorganized into labor groups which were newly set up to be the basic units of the contract responsibility system.

It should be pointed out that labor-force rationalization is the most difficult part in intra-enterprise reform, for in the presence of large unemployment, dismissed workers can hardly hope to find alternative jobs. There are 11–12 million new job seekers each year. In 1988, government agencies and state-owned enterprises employed 4,920,000, and collective enterprises in the cities employed another 2,630,000, thus giving employment to only 7,550,000 new job seekers. Most of the remaining job seekers found employment as peasants, at small enterprises in rural districts, or were self-employed. When a state-owned enterprise dismisses workers, the first fired are extra-plan workers (temporary workers). They do dirty, hard, and inferior (zang, lei, cha) jobs that regular workers do not want to do.7 There is a total of 13 million such workers. If they are dismissed, few regular workers would refuse to take over their jobs.8

Performance of Mining and Manufacturing Enterprises

The above-mentioned enterprise reforms, coupled with other economic reforms, have contributed greatly to the development of Chinese economy since 1979. Let us take a look at the achievements made by mining and manufacturing enterprises in the ten year period from 1979 through 1988.9

In material terms, the output of coal, crude oil, iron and steel, chemical industrial materials, construction materials, machines and equipment, textiles, and twenty-four other items increased 2–4.5 times between 1978 and 1988. In value terms, mining and manufacturing output continued to grow at an average annual rate of 11.1 per cent in the same ten years. The output of state-owned enterprises whose growth was slower than that of the other sectors also achieved an annual growth of 8.2 per cent in the same period. Their sales increased faster at an annual rate of 11.5 per cent. Profits earned by the mining and manufacturing sector also increased 9.7 per cent annually. Profits earned by state-owned enterprises registered an annual increase of 7.6 per cent.

Improvements were also seen in economic efficiency. The norm of materials consumption per unit of product improved between 1978 and 1988 for sixty-six of the ninety-three products produced by major mining and manufacturing enterprises. Labor productivity also climbed 5.1 per cent per annum during the same period.

But not all economic efficiency indicators at the enterprise level improved. The cost-profit ratio, fund-profit ratio, sales-profit ratio, and the rate of cost reduction deteriorated.10 This reflects slow progress in technological innovation.

Chinese enterprise reform thus has brought about significant improvements
in institutional aspects as well as enterprise performance. This should be clearly recognized in evaluating China’s economic reforms and open-door policy. It is also true however that progress has been slow with regard to labor force rationalization and economic efficiency. As with the reform program as a whole, Chinese enterprise reform now faces serious troubles, forcing a review of what has been done. In the pages that follow, I deal with contradictions in the enterprise reform program, situating them in the context of the general trend in the China’s economic reforms.

The Extension of Enterprise Powers

The Two Lines of Reform

The reform of the Chinese economic system undertaken since the end of the 1970s has followed two main lines as mentioned in Chapter 2. One is the introduction of the market mechanism. Setting production goals by directives, traditionally the chief method of administrative control, has been reduced and largely replaced by resource allocation through economic means such as prices, interest rates, and taxes. The reform measures taken along this line were intended to liberalize prices from government controls and encourage the formation of markets for producer and capital goods, finances, and labor. Particularly important were commercial and price reforms. This was the key to the whole reform program that rested on the introduction of the market mechanism. But it was precisely in this area that the reform program met a number of serious problems and had to be slowed as it entered the implementation stage. Lifting of price controls threatened to cause inflation. Under the multiple price system under which government-determined, government-guided, and market prices coexisted, the opening of producer- and capital-goods markets facilitated rampant black-marketeering of government-controlled goods by bureaucrat brokers. The formation of a labor market has also been difficult given the vast amount of unemployment population including disguised unemployment.

Chinese fiscal and financial reforms involved a shift from coercive administrative control, has been reduced and largely replaced by resource allocation through economic means such as prices, interest rates, and taxes. The reform measures taken along this line were intended to liberalize prices from government controls and encourage the formation of markets for producer and capital goods, finances, and labor. Particularly important were commercial and price reforms. This was the key to the whole reform program that rested on the introduction of the market mechanism. But it was precisely in this area that the reform program met a number of serious problems and had to be slowed as it entered the implementation stage. Lifting of price controls threatened to cause inflation. Under the multiple price system under which government-determined, government-guided, and market prices coexisted, the opening of producer- and capital-goods markets facilitated rampant black-marketeering of government-controlled goods by bureaucrat brokers. The formation of a labor market has also been difficult given the vast amount of unemployment population including disguised unemployment.

Chinese fiscal and financial reforms involved a shift from coercive administrative control over all types of financial operations to a “window guidance” type of control based on moral suasion. But conditions are not ripe for the formation of a unified financial market. When financial markets exist only locally, it is difficult to fully and effectively apply the orthodox financial control methods composed of official discount rate policy, open market operation, and reserve requirements policy. The recent expansion of credit in China is largely a product of this contradiction specific to a transitional period.

The other line pursued in economic reform is decentralization of decision-making powers to enterprises and local governments. This centers on the expansion of autonomous management powers of enterprises. There being little resistance to decentralization, reform progressed fastest in this area. But sluggishness in market mechanism introduction has influenced the course of decentralization.

The Three Stages of Enterprise Reform

Expansion of enterprise powers is central to China’s decentralization reforms. From 1978 through 1986, enterprise reform was successfully carried out through the following three stages.12

The first stage was from October 1978 through 1980 during which an enterprise fund system was experimented with at state-owned enterprises. Under this system, the enterprise would retain 3–5 per cent of the total wage amount in accordance with the degree of fulfillment of production, quality, profit, and cost goals. The enterprise fund thus created was to be appropriated for welfare benefits and bonuses for the employees. By the end of 1980, 6,600 enterprises, or 16 per cent of manufacturing enterprises covered by the national budget, were following this system on a trial basis.

The second stage was from the summer of 1981 through early 1983. During this stage a system of profit-delivery responsibility was introduced into manufacturing enterprises. Those enterprises which had fulfilled the contracted quotas were allowed to withhold part of the profits. This system was adopted by 36,000 enterprises by the end of 1981.

In the third stage that ranged from 1983 through 1986, a corporate tax system was introduced on an experimental basis. In June 1983 state-owned enterprises began to pay corporate income taxes instead of delivering profits to the government. This was the introduction of the first version of the corporate tax system. The tax rate was 55 per cent for large and medium-sized enterprises, and eight categories of progressive rates were set for small enterprises. Of the after-tax profits, portions were paid to the government in the form of contracted profit transfer and adjustment tax, and the remaining portions were withheld as reserve funds. In actual cases, corporate taxes coexisted with the traditional profit transfer at the first version of the third stage.

The second version of the corporate tax system was introduced in October 1984. The new system abolished direct profit transfer in favor of corporate taxes as the single form of profit transfer to the government. The business consolidated tax was levied on the sales revenue gained by each enterprise belonging to the mining, manufacturing, commerce, trading, transportation, or service industries) was abolished and divided into a commodity tax (chanpin shui), value-added tax (zengzhi shui), salt tax (yan shui), and sales tax (yingye shui), levied according to business categories. Simultaneously, the land use tax and the city maintenance and construction taxes were introduced.

China’s enterprise reform effort was geared to provide incentives to an enterprise by linking the amount of internal reserves it could withhold to its achievements. In this sense the unification of corporate tax systems was understood to be one of the final goals in the reform program, for under this system the
enterprise would break free from the administrative controls of government offices there by securing its after-tax profits for use at its own discretion.

Reemergence of the Contract Management Responsibility System

Though the unification of corporate tax systems was considered one of the final goals of enterprise reform, it was clear that in the Chinese situation the tax system would not play its expected role because its function would be impeded by the skewed price system. Under the existing Chinese economic system, the amount of profit earned by an enterprise is determined not so much by the quality of management as by whether the government-set price of its products is high or not. In fact, the unbalanced price system set by the government is causing raw materials and energy industries to register losses while ensuring high profit rates for processing industries.

When a uniform tax system is applied to all enterprises where prices are irrationally set and a competitive market environment is absent, the inevitable outcome is growing income gaps among enterprises subject to different external conditions. Such income gaps generated by unequal competitive conditions (ku-le bu jundeng—the phenomenon of sufferings and blessings not equally shared) must be rectified. For this reason, the idea of uniformly applying the corporate taxes had to be abandoned. Instead, a regulatory income tax was introduced to complement the corporate taxes and to mitigate inter-enterprise differences in after-tax profits. Administrative interference by government offices has thus been called back in at the cost of the original idea of uniform corporate taxes.13

The enterprise reform program entered its fourth stage at the end of 1986. This stage was marked by the reintroduction of the contract management responsibility system. In that year the government intended to fully revise the prices of producer goods, but had to give up its price reform plan as inflation which had started in the previous year began to gallop.14 While efforts to set equal competitive conditions for all enterprises failed, reform measures to increase enterprise powers were still continued. But if all enterprises had the same degree of autonomous powers when their external conditions were unequal, they would certainly suffer from unfair income distribution. In order to prevent this, the government offices in charge would have to regulate the powers of enterprises in accordance with the latter’s respective business situation and external circumstances.

It was to meet this requirement that the contract management responsibility system was reintroduced. This system is basically the same as the contract system practiced during the second stage of reform (1981–83). Indeed it marked the reform’s return to the second stage. In 1988 this system was applied to more than 90 per cent of the state industrial and commercial enterprises all over the country, and 95 per cent of the large and medium-sized state industrial enterprises.15 The new contract management responsibility system is subdivided into several categories as explained in Chapter 3, The Contract Management Responsibility System.

Vicious Cycle

In Jilin Province which has developed the contract management system more widely than any other province, ten versions of this system are followed as Table 4-2 indicates. The system in Jilin Province suffers from the following problems.16

First, the contract term is too short, only one year for two thirds of the enterprises. This makes enterprise behavior myopic.

Second, the contract norms are individually agreed upon by each enterprise and the government agency in charge. Consequently, the retained profit amounts vary greatly from enterprise to enterprise, the gap between the largest and smallest even reaching fifteen million yuan or so. The differences moreover do not reflect the good or bad quality of the management but the good or bad bargaining ability of the enterprise vis-à-vis the government agency.

Third, bonuses are increasing. At profitable enterprises the annual bonus has reached the allowable ceiling of 4.5 months regular pay. Ten major enterprises in the province have accumulated bonus funds totaling 7.5 million yuan, which are waiting for the additional disbursement to be permitted.

Fourth, investment in other industrial areas is barred as each enterprise must
confine its activities to the business area defined by the contract it has with the government agency in charge. This practice hampers necessary industrial restructuring.

Fifth, the cost of activities and mechanisms required for intra-enterprise monitoring and bargaining with other bodies and individuals has increased greatly. At the Changchun Automobile Plant, forty units comprising 351 persons had to be organized simply to check whether the contract norm was being fulfilled as planned.

Under the contract management responsibility system, a production norm is set for each individual enterprise in accordance with its business performance and the given price level. In setting the norm, taojia huanjia (bargaining) between the enterprise and the government agency in charge carries the greatest weight. A manager’s worth is tested in this bargaining: an able manager is one who succeeds in bargaining a low contract norm.

Therefore the size of retained profit depends not so much on whether an enterprise’s business performance is good as on the bargaining power it can wield.17 The enterprises chronically registering losses have no potential for profits. In their case they contract to reduce their losses to a promised level. If they succeed in overfulfilling this loss reducing norm, the difference is retained by them. No matter whether in the black or in the red, the enterprise thus can increase its internal reserves. Table 4-3 shows the shares of retained profits out of the total profits generated by state-owned enterprises. As is clear from the table, the shares began to increase rapidly after reforms were launched in 1978.

As mentioned in Chapter 3, the contract management responsibility system is a product of compromise amongst all the economic bodies involved. However, from the point of view of thorough economic reform, this system is far from satisfactory as it does not modify the fundamentals of the traditional system.18 The enterprise remains subjugated to administrative agencies. Even if an enterprise continues to suffer losses over years, it not only does not go bankrupt but can continue to pay the same wages and even bonuses.

People are still eating “a big pot of rice” (daguo-fan) from the “iron rice bowl” (tie-fanwan), having no fear of losing privileges. Budget constraints on enterprises still remain soft. This is why the contract management responsibility system is often characterized as a “reform that has not modified the benefit allocations under the traditional system.”19

Already in 1980, Xue Muqiao pointed this out in his treatise on the “vicious cycle.”20 According to him, the complicated formula giving government agencies in charge powers to determine the profit retention rates for individual enterprises presupposed irrational relative prices of commodities and thus in the end impeded progress in price reform (Figure 4-1). As government activity reports have repeatedly admitted since the early eighties, introduction of the market mechanism centering on price reform is the key to economic reform. Nevertheless, it would be premature to carry out price reform across the board when gross demand still largely exceeds gross supply. To carry out such reform now would kick off inflation and invite social turmoil. On the other hand, preserving the present irrational price system will keep the decentralization reforms in the strait jacket of the traditional system.

The Market Mechanism Does Not Function

Market-oriented Reform

When the market mechanism functions normally, prices go down if supply exceeds demand and go up if demand exceeds supply. Reacting to price fluctu-
is rapidly diminishing, giving way to government-guided prices (fluctuating with
tional and inconsistent price system, profit-rate gaps are bound to develop among
As was earlier said, Chinese economic reforms since the end of 1978 purport
cannot take place under such circumstances. To be sure the reform efforts to decentralize the economy and introduce the
market mechanism have marketized the Chinese economy to a remarkable
degree. The weight of government-determined prices in the sales of various goods
function of price, and the patterns of resource and income distribution are
determined accordingly.

As was earlier said, Chinese economic reforms since the end of 1978 purport expansion of enterprise autonomy and introduction of the market mechanism. In other words, the reforms aim at creating a situation where macroeconomic equilibrium is attained as the result of competition among individual enterprises acting to maximize their respective profits. The wages and fringe benefits of the employees are to be linked with the amount of profits their enterprise obtains. But for such a system to function more or less smoothly, a fair competitive environment should first be provided to enterprises. It is therefore logical that price reform to adjust relative prices and abolish the officially determined prices should have emerged as a crucial policy task. Obviously under an irrational and inconsistent price system, profit-rate gaps are bound to develop among industries and enterprises irrespective of their performance. Fair competition cannot take place under such circumstances.

To be sure the reform efforts to decentralize the economy and introduce the market mechanism have marketized the Chinese economy to a remarkable degree. The weight of government-determined prices in the sales of various goods is rapidly diminishing, giving way to government-guided prices (fluctuating with
thin government-designated margins) as well as market-adjusted prices. Reflecting different degrees of government intervention and market adjustment, the same commodity thus has come to have more than one price, a phenomenon known as multiple prices.21

Expansion of the Non-commodity Economy

The diminishing weight of government-determined prices does not immediately mean full functioning of a market economy. Multiple prices obstruct fair market competition. The market-oriented reforms have on the one hand reduced the degree of government control, but on the other hand have not weakened and even strengthened trends in the non-commodity economy.

One trend is the increasing activity in the bartering of goods. China has been for years an economy suffering from shortages of goods. The introduction of the market mechanism of course has not eliminated this imbalance between supply and demand. Under these circumstances commodities whose demand is larger than supply sometimes function similar to hard currency. Table 4-4 gives exchange rates of various commodities against coal. These rates were set through consultations by the State Bureau of Materials and Equipment, the State Administration of Commodity Prices, the State Economic Commission, and the State Planning Commission. These rates are applied when a supply-side enterprise directly deals with a demand-side enterprise outside of the scope of planned distribution. Here commodity prices hardly function as a value indicator.

Even when there are market prices, bartering not based on money value is frequently carried out with commodities in short supply. Steel and aluminum are a case in point. The market price of steel is two thousand yuan per ton and that of aluminum ten thousand yuan per ton. But in actual practice, five tons of steel is bartered directly for one ton of aluminum. Money here fails to play its role as the general means of exchange.22

Central government control has been curtailed, but this does not mean the diminishing of control itself. The State Planning Commission in 1988 gave mandatory production directives for only 60 kinds of mining and manufacturing products compared with 120 in 1984, and the share of goods under state control also declined from 40 per cent to 17 per cent of total mining and manufacturing output. However, in lieu of the State Planning Commission, other government agencies, both central and local, were giving the directives for norms to enterprises in their respective jurisdictions.23 A survey made in 1984 (Table 4-5) showed that the share of mandatory planning increased as echelons went down from central to provincial and from provincial to municipal.

The State Council regulations promulgated in May 1984 imparted limited autonomy to enterprises in ten business categories including production, marketing, pricing, material purchasing, investment, personnel assignment, and wages. But the enterprises feel that they have been given but limited powers of management. Table 4-6 contains replies to a questionnaire on this matter sent to state-
inflation began in the summer of 1988. Rationing was thus introduced for eggs, exchangeable goods. But rationing coupons were revived one after another when...commodity relations in goods distribution. There are similar other data. The directives for norms the State Planning Com-

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<tr>
<th>TABLE 4-4</th>
<th>COAL EXCHANGE RATES WITH OTHER COMMODITIES</th>
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<tbody>
<tr>
<td>Coal (Ton)</td>
<td>Steel (1 ton) 11–20</td>
</tr>
<tr>
<td></td>
<td>Zine / aluminum (1 ton) 30–50</td>
</tr>
<tr>
<td></td>
<td>Lumber (1 cubic meter) 11–20</td>
</tr>
<tr>
<td></td>
<td>Sheet glass (1 standard box) 1.2–1.5</td>
</tr>
<tr>
<td></td>
<td>Soda ash / caustic soda (1 ton) 12–20</td>
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<td></td>
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Source: Jingji ribao, November 19, 1983.

<table>
<thead>
<tr>
<th>TABLE 4-5</th>
<th>PERCENTAGE SHARE OF PLANNING IN PRODUCTION (%)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Centrally Planned</td>
</tr>
<tr>
<td>Share of mandatory planning</td>
<td>12.44</td>
</tr>
<tr>
<td>Share of guided planning</td>
<td>9.48</td>
</tr>
</tbody>
</table>


Note: One hundred per cent for total production volume; the provincially planned volume includes the centrally planned volume; and the municipality planned volume includes the provincially planned volume.

owned enterprise managers in Shanghai. As the replies show, few enterprises have full autonomous powers on planning, personnel assignments, finance, and pricing. There are similar other data. The directives for norms the State Planning Commission gives to Shanghai cover only 18 per cent of the local mining and manufacturing output value. But a different picture appears if the situation is probed from the enterprise side. It is found that almost 100 per cent of the major products in the metallurgical industry and in cotton spinning and weaving as well as some sectors of the machinery industry are bound by mandatory plans. In some cases, output above the norms is incorporated into the mandatory planning.24

A second trend is the development of non-commodity relations in goods distribution.25 Commodity rationing coupons exchangeable for specific goods were in use for 102 items in Beijing and 92 items in Shanghai in the sixties. Even in the seventies coupons covered 72 items. After the economic reforms were launched, coupons were gradually phased out so that in the first half of the eighties only grains, edible oils, and cotton cloth remained as coupon-exchangeable goods. But rationing coupons were revived one after another when inflation began in the summer of 1988. Rationing was thus introduced for eggs, meat, sugar, bean jelly sticks, toilet paper, soap, detergents, and other daily necessities. Under the adjustment policy in 1989 and 1990, 85-95 per cent of grains, edible oils, eggs, and meat for home consumption were rationed by local governments.

Non-commodity economy is carrying in determining the fringe benefits provided by enterprises and other units. The share taken by house rent in an urban household's living expenses per head was 2.32 per cent in 1957 and 2.61 per cent in 1964. This share slipped to 1.52 per cent in 1983 and further to 0.71 per cent in 1988. This is because rent is frozen in the range of 7.7-7.8 yuan.26 This means that housing subsidies have been increasing. It is reported that public subsidies for housing, food rationing, medical services, and education amount to 80 per cent of the average wages and salaries of staff and workers.27 High-ranking cadres are paid a monthly salary of 250 yuan which is only two times higher than the national average. But such cadres can avail themselves of a personal chauffeured car, telephone, cadre house, special medical services, government-paid maid servants, and specially rationed goods. Such cadres thus receive benefits equivalent to three thousand yuan a year, and their real income is easily four times as high as the national average wage. Leading cadres at or above the vice-bureau director level are said to number only 90,000 nationwide, but those who enjoy this level of privileges are estimated at 210,000 or more.28

Many commodities are rationed within the enterprise and other units exclusively to their constituent members. Of the high grade rice consumed by staff and worker families in Beijing in October—December 1987, 40 per cent came from the units they belonged to in the form of special rationing. They received rice at a price 70 per cent lower than the market price. A survey conducted of...

<table>
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<tr>
<th>TABLE 4-6</th>
<th>AUTONOMOUS POWERS DELEGATED TO STATE-OWNED ENTERPRISES IN SHANGHAI</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Powers</td>
<td>Partial Powers</td>
</tr>
<tr>
<td>Number of Replies</td>
<td>%</td>
</tr>
<tr>
<td>Planning</td>
<td>67</td>
</tr>
<tr>
<td>Control over production</td>
<td>202</td>
</tr>
<tr>
<td>Personal matters</td>
<td></td>
</tr>
<tr>
<td>Cadre appointment rights</td>
<td>53</td>
</tr>
<tr>
<td>Worker dismissing rights</td>
<td>36</td>
</tr>
<tr>
<td>Financial</td>
<td>37</td>
</tr>
<tr>
<td>Price decisions</td>
<td>34</td>
</tr>
<tr>
<td>Sales</td>
<td>114</td>
</tr>
</tbody>
</table>

Source: Tao Youzhi et al., "Shanghai quannin qiye jingyinghe ze, quan, li diaocha" [An investigation of responsibility, authority and interests of managers in the state-owned enterprises of Shanghai], Jingji yanjiu, 1988, No.4, p.69.

Note: Survey questionnaire sent to 322 enterprises.
200 households in Shanghai, 70 per cent of them purchased New Year goods from the units they belonged to at a 30 per cent discount. If half of the 100 million urban households throughout the country purchased New Year goods at a price discounted 30 yuan per household, this would be equivalent to their receiving 1.5 billion yuan worth of free foods every year, about the same as the value of canned foods sold across the country in 1987. A survey taken in 1988 in Sichuan said that the "concealed wage" per capita not appearing in wage statistics nor on the bank books amounted to 36.46 per cent of the average wage in the province. The concealed wage according to the survey consisted of various cash-paid benefits, provision of benefits in kind, and diverted administrative funds.

Enterprises distribute to their employees their own products as well as products they purchase from other enterprises. For this purpose large volumes of goods are exchanged between enterprises. For instance, steel products are bartered for passenger cars, gasoline for color TV sets, and chemical fertilizer for grain, fish, and meat. Grain rationing coupons are exchanged for eggs. Those in power can use inside tracks to favor petitioners, and in return they can expect to receive such items as refrigerators or color TV sets. On every festivity day enterprises give special rations. Banquets and outings at public expense have become rampant. Such spending flourished to such a degree that the State Statistical Bureau in its official bulletin in 1988 deplored it saying that "collective consumption in kind carries an enormous weight and personal favor and corruption are widespread. Hua Sheng et al. in their article analyzed why the lifting of price controls did not lead to the formation of market prices. First, they pointed out that most government agencies, using their authority, force enterprises under their control to sell their products at low prices. In some areas, local governments even close the local market to create multiple prices.

Second, they said a situation exists where priorities are given to "small interests of private individuals" rather than to "big interests of large bodies." Individuals and small units belonging to the branches of the State Bureau of Materials and Equipment often sell at low prices in exchange for kickbacks. Bureaucrats having norm allocating powers face temptations to take bribes. For the enterprises on the buying side, whether they can obtain production materials at the official price or only at the market price makes a great cost difference. The norm license thus can serve as an instrument connecting administrative powers to money.

Third, in China the goal of enterprise behavior is not profit maximization but enterprise-welfare maximization. Thus an enterprise can still be considered to be acting rationally even if it sells its products at a lower price, or even for no price, provided that by doing so it can expect to draw benefits for itself and its employees in the form of preferential taxes and financial treatment.

Fourth, the Chinese economy is subject largely to administrative authority and personal connections and not yet fully based on a money economy. Even if one has money, one cannot always expect to be able to buy commodities. In this situation everybody has to depend on the personal favor of, or ties to, those in positions of power.

Fifth, state-owned enterprises still hold monopoly positions. In 1985 the dual government purchase price of grains (state listed prices and higher prices for above-quota purchases) was abolished and replaced by a unified purchase option price. But that eventually turned out to be another official price.

As all these cases illustrate, the weakening of administrative control on the economy at the national government level has not necessarily led to the expansion of autonomous powers at the enterprise level. Nor has the abolition of price controls helped the price factor to perform its expected barometer-like functions. Thus it cannot be said that the price mechanism is functioning normally at China's present stage of reform.

Reform Inconsistencies and Enterprise Behavior

"Honest Men Are Losers"

China's economic reform program at present is at a dead end. The abolition of central government economic control has not generated fair market competition. Instead the structure of the economy has become more complicated and multifarious; contradictions and conflicts have become aggravated. In this socioeconomic environment, Chinese enterprises have developed peculiar adaptive behavior generated by the pattern of economic reform during the past decade.

The first characteristic of enterprise behavior is linked to the inconsistencies between the reform measures which have been carried out at the macro and micro levels. While the market-oriented aspect of the reforms was initiated but later stalled, the traditional macro control system has remained intact. At the same time, however, the micro-level enterprise reforms transferring powers to enterprises has continued to be promoted. Consequently two diametrically opposed economic mechanisms have come to exist side by side in a single national economy. On the one hand, enterprises which have been placed outside of government control are completely free, subject to no government control, direct or indirect. On the other hand, those enterprises which have remained under the old system are still unable to act on their own discretion.

The second feature determining enterprise behavior has been that the transfer of power to enterprises has not been in conjunction with them taking responsibilities and risks for their action. For this reason enterprises have generally taken the attitude that they will follow the reforms if and only if these bring explicit and direct benefits to them. Otherwise they will not accept reform.
The third feature is that reforms which promised direct benefits to the enterprises could not be applied simultaneously all over the country, but had to be confined to specific areas and industries, such as special economic zones, coastal open cities, jiuhu danlie chengshi (cities given the power to plan independently of their provinces), and industries that introduced the contract management responsibility systems. The areas and industries singled out for preferential treatment have become special areas where macro control practically does not function. Taking advantage of such disjunctive systems, shrewd enterprises and individuals play their games. This is a circumstance in which honest people lose. The “dishonest” use this opportunity to promote their self-interests committing all kinds of irregularities, and this phenomena is spreading.

The geographically uneven preferential treatment generates regional disparities. The regions not favored become discontented. Raw materials produced in inland regions where prices are kept low naturally flow to coastal areas where the prices for the same products are high. The inland regions thus suffer from shortages of materials and the local governments have had to close their borders. What is called zhuhou jingji (parochialism) appears in some provinces and regions where the local governments and local industries are united in pursuit of their exclusive interests.

The fourth feature is that administrative powers are commodified. As the commodity economy expanded, the government agencies and bureaucrats monopolizing material allocation rights and business licensing powers have developed the art of translating their powers into business transactions and maximizing their particular economic interests. In the absence of market mechanisms, bribery, nepotism, and personal favor are the only means of influencing the economic processes. Bureaucrat brokers (guandao) have taken over, and paper companies established by the government agencies and the party organizations have become fashionable. Shops and other commercial units increased from 1,260,000 in 1978 to 12,670,000 in 1988. The number of gongsi (companies partially characterized as government agencies) grew from 270,000 in 1985 to 477,000 in 1988, 39 per cent of them established in the second half of 1986.

The inconsistency in the reform program and the delay in the formation of institutionalized markets have created major pockets in the economy where no control is practiced. These pockets have created opportunities of windfall profits. Official and private bodies are frantically running after such profits. This situation has resulted from contradictions arising from the reforms. Table 4-7 provides an extensive list of the forms of corruption by individuals, party organizations, administrative offices, and enterprises, in the areas of organizational management, law enforcement, production, and distribution.

The Struggle over Quasi Rent

How are the “pockets” created by the reforms explained in economic terms? The pocket is most graphically explained by the emergence of “quasi rent” due to the dual pricing system.

Quasi rent is usually defined as the producer’s surplus generated by the difference in advantages enjoyed by enterprises. Figure 4-2 provides an explanation. SS’ is an industry’s supply curve and DD’ is its demand curve. OH is the output under conditions of supply-demand equilibrium. Within an industry are enterprises having relatively good advantages and others having no advantages to speak of. In the figure, the enterprises in a specific industry are arranged on line OH in accordance with the degree of advantage enjoyed in production cost and output. Advantage decreases as you go from the most advantaged enterprise in the left to the least advantaged enterprise in the right. In a complete market economy, P\textsubscript{i} shows the equilibrium price per unit of output. The OH\textsubscript{th} enterprise on the line have no relative advantage, but the OM\textsubscript{th} enterprise have.

In this case, QM minus RM, namely, QR, is the quasi rent that the OM\textsubscript{th} enterprises obtain.

Now let us examine a completely controlled economy. There, the total output, that is OH, is sold at the official price PO. In this case, the total quasi rent, PO\textsubscript{SR}, is recovered by the state and then used to compensate less advantaged enterprises for their losses, namely, ARK.

Under the dual pricing system where the market and official prices coexist, there is the possibility of goods which are supposed to be sold at the official price being sold at the market equilibrium price P\textsubscript{i}. Therefore, for the enterprises between O and M, P\textsubscript{i}PO\textsubscript{R}, which is the differential between the market price P\textsubscript{i} and official price PO\textsubscript{R}, emerges as quasi rent. Also, Q\textsubscript{RAQP}, the differential between the sales price and production cost, is another portion of quasi rent. Thus fierce struggles occur to win the lion’s share quasi rent, PO\textsubscript{R}AQP. In this struggle enterprises do all they can to sell products through illegal channels and buy goods for resale. Meanwhile government agencies and their bureaucrats try to make fortunes using their power to issue goods distribution permits.

How large are quasi rents? Hu Heli calculated the amount of quasi rents arising from the dual pricing system using the following formula:

$$R = \sum_{i=1}^{\sigma} (P_{i} - P_{o})Q_{i},$$

where R = quasi rent, P\textsubscript{i} = market price of ith item, P\textsubscript{o} = official price of ith item, and Q\textsubscript{i} = volume of extra-plan sales of ith item.

According to his calculations, quasi rents totaled 356.9 billion yuan. He broke this down into 150 billion for the differential between the official and market prices of government-controlled commodities, 113.88 billion yuan for the differential between the official and market interest rates, and 93.04 billion yuan for the differential between the exchange rate applied to imports and the market exchange rate. The quasi rent total was equal to 25.5 per cent of China’s GNP in 1988. If the nation’s high ranking bureaucrats skimmed off 5 per cent of the total, they may have easily pocketed 17.8 billion yuan. If so, they would have embezzled far more money than the total wages and salaries of 8.17 mil-
TABLE

<table>
<thead>
<tr>
<th>Types of Corruptions in Lowest and Party</th>
<th>Corruption in Enterprises</th>
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<tbody>
<tr>
<td>Management</td>
<td></td>
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<tr>
<td>Patriarchal domination</td>
<td>Nepotism and other</td>
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<tr>
<td>corruption, and bribery  (to protect</td>
<td>underhanded dealings</td>
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<tr>
<td>relatives and acquaintances</td>
<td>(through relatives)</td>
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<tr>
<td>Bribing and other irregularities (on</td>
<td></td>
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<tr>
<td>behalf of employee collectives or in</td>
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<tr>
<td>economic action)</td>
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<tr>
<td>Protection</td>
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<td>Protecting relatives or acquaintances</td>
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<td>having committed economic crimes</td>
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<td>Speculation and other</td>
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<tr>
<td>economic crimes</td>
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<td>Provision of modern equipment for</td>
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<td>relatives</td>
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<td>Setting up sub-contract enterprises to</td>
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<tr>
<td>profit relatives and acquaintances</td>
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<td>Contracting with specific selling</td>
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<td>enterprises on preferential conditions</td>
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<td>Special favors for relatives and</td>
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<td>acquaintances</td>
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<td>Bribes and gifts to obtain preferential</td>
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<td>treatment</td>
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<td>Provisions of preferential</td>
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<td>treatment in housing for relatives</td>
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**Distorted Enterprise Behavior**

Given the above-mentioned immaturity of the market mechanism, lack of consistency between reform measures, and resultant presence of pockets, the behavior of Chinese enterprises at the present reform stage still deviates from that of an "orthodox enterprise." By "orthodox enterprise" is meant an enterprise which, in its pursuit to maximize profits, actively promotes research and development, makes investments, extends marketing, and procure financing, thus endeavoring to increase productivity and achieve technological progress and finally to accumulate a significant volume of profits for its further growth and development.38

In the Chinese economic reform program, priorities were given to the decentralization of power to enterprises. This was intended to create orthodox enter-

prises. In the area of laws and regulations, Chinese enterprises have acquired greater autonomy over production, research and development, marketing, employment, wages, internal reserves, equipment expansion, and merger with other enterprises. Even so, more than ten years after the reforms were launched, the corporate behavior of the vast majority of Chinese enterprises remains far different from that of orthodox enterprises. They do not fully exercise legally recognized powers regarding research and development, technological innovation, and the expansion of internal reserves. Rather than winning new customers through active marketing, they seek to profit by dint of the differential between the official and market prices. Instead of increasing internal reserves, they prefer to appropriate profits for bonuses and fringe benefits to their employees.39

A survey conducted of 149 state manufacturing enterprises in Harbin City revealed the uses of retained profits as shown in Table 4-8. There is a regulation that the share of the production development fund should be 50 per cent...
or more of the total retained profits, but this regulation is not honored. Enterprise welfare costs are above 50 per cent in all cases.40

Organizationally the enterprise has been revamped as a body operating to maximize profits. But the actual behavior of the now largely autonomous enterprise has not fulfilled the expectations of the reforms. Case studies on distorted enterprise behavior have been conducted by the Institute of Economics of the Chinese Academy of Social Sciences. The studies covered forty state-owned enterprises located in cities and counties in Wuhan, Changsha, Zhenjiang, and Lin'an.41 According to the studies, the behavior of these enterprises deviates from that originally expected to arise from the economic reform program in that they pursue their individual self-interests in the procurement of funds, product marketing, inventory formation, and decision making. Below are examples of enterprise behavior taken from the institute's case studies.

**Fund procurement**

Inflation spiraled in 1988. The price of zinc, the mainstay raw material of the Zhenjiang City storage battery factory, soared 2.6 times on the open market between January and September of that year. But the amount of zinc procurable under the economic plan, which accounted for 43 per cent of the total zinc consumed at the factory in 1987, was reduced to only 20 per cent in 1988, only half of which was actually allocated. Finding funds to buy the raw material became a life-or-death matter for this enterprise.

In this context, the Chinese enterprise's capacity to pay for raw materials depends on its ability to obtain bank loans. An enterprise at Wuhan City, having fixed assets worth only 500,000 yuan, was able to draw a 25 million yuan bank loan because its director had strong personal connections with bank officials.

**Product marketing**

Commodities in short supply are now a more powerful means of exchange than money. Because of this, local governments are anxious to keep scarce and precious local commodities under their direct control in order to utilize their exchange value for the benefit of the local economy and specific individuals. By accepting such control, enterprises have to deliver their products at low prices, but they are compensated by preferential treatment in the forms of low or no taxes, better access to loans, easy permission to investment, and higher ceilings for bonus funds. To receive the title of “excellent entrepreneurship” also benefits enterprise managers. These all serve as incentives for the enterprise. A steel mill at Hunan Province thus is delivering 95 per cent of its products to the government at low official prices, which are one tenth of the market prices.

**Inventory formation**

Wuhan radio and telecommunication equipment factory usually needs a two-month inventory of plastics for video tape-recorders. But a survey made in September 1988 showed that the factory had a plastics inventory that would keep it running for one year.

There is also a tendency for enterprises to stock raw materials which are irrelevant in kind, standard, and quality, to their actual production. They keep such materials in the hope that they can exchange them for materials they need for production. In other cases, large stocks of unrelated goods are held just
for resale and profiteering. An enterprise in Lin’an County bought ten thousand tons of coal and resold it three months later. This brought it a profit of one million yuan.

As bonuses are often paid in kind, a factory’s inventory includes daily necessities for this purpose. There is even an enterprise which built a refrigerated warehouse simply to stock chickens for distribution to employees on festival days.

**Price determination**

Fifty-six enterprises in Zhenjiang City were forced to spend 42 million yuan extra following raw material price hikes between January and June 1988. These enterprises increased their revenues by 48 million yuan by raising the prices of their products. Their cost increases were thus 114.3 per cent shifted onto their product prices. Few enterprises strive to absorb raw material cost increases by rationalization and other means of cost reduction.

These examples of distorted enterprise behavior resulting from insufficient operation of the market mechanism characterizes not only state-owned enterprises but also township- and village-run enterprises (xiangzhen qiyu). They pursue temporary interests by utilizing connections with local government officials, or even by selling fake drugs, fake wines, and the like. In coastal cities like Wenzhou, local self-employed merchants and private enterprise owners openly exchange bundles of small banknotes valued at 103, 104, or even 105 yuan, for a single 100 yuan note, taking advantage of the fact that a larger note is more convenient for carrying to distant places and for bribing. Cash transactions make sense for tax evasion as well as for the blackmarketeteering of scarce commodities.

**Medium- and Long-term Perspectives of Economic Reform**

**Marketization of Economy Progressed Even under Adjustment Policy**

The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The only way would be to go slow and steady in full recognition that full marketization is a long-term task.

The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The number of consumer retail shops has become eight times and the various markets whose opening had been prepared at the 1988 height of reform and open-door upheaval were inaugurated one after another during the adjustment period. The number of consumer retail shops has become eight times and the various markets whose opening had been prepared at the 1988 height of reform and open-door upheaval were inaugurated one after another during the adjustment period. The number of consumer retail shops has become eight times and the various markets whose opening had been prepared at the 1988 height of reform and open-door upheaval were inaugurated one after another during the adjustment period. The number of consumer retail shops has become eight times and the various markets whose opening had been prepared at the 1988 height of reform and open-door upheaval were inaugurated one after another during the adjustment period. The number of consumer retail shops has become eight times and the various markets whose opening had been prepared at the 1988 height of reform and open-door upheaval were inaugurated one after another during the adjustment period.

The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The Chinese economic reform is now caught on the horns of a dilemma. The number of consumer retail shops has become eight times and the various markets whose opening had been prepared at the 1988 height of reform and open-door upheaval were inaugurated one after another during the adjustment period. 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Considering what has happened in the areas of price reform, inauguration of markets, and external economic exchange, China has not retreated into the past. As shown in Table 4-1 at the beginning of this chapter, not only reformist scholars but top leaders such as Jiang Zemin proposed the establishment of the “socialist market economy” in summer of 1992. This proposal explicitly surpassed the dimension of the “planned commodity economy.” Chinese economic reform has entered the forth stage. It is therefore important to examine here what market economy model China envisages in the future.

Outline of Medium- and Long-term Planning

I pointed out that the Zhao Ziyang report at the 14th National Congress of the Communist Party of China in the autumn of 1987 made an epoch in China’s history of economic reform. Referring to how economy should be managed, Zhao proposed this formulation: “the state to regulate the market and the market to guide enterprises.”

Liao Jili, vice-chairman of the China Economic System Reform Society, said that under this system of economic management, consumption goods, producer-goods, services, finances, and labor forces were all to be channeled through market transactions and that the government would exercise macro control mainly through its fiscal and financial policies. A conceptual model of reform has thus been already proposed, but the Chinese government has not yet shown us how this is to be evolved into systematic practice. To do so, a medium- and long-term reform design would be required. In the autumn of 1987, the State Commission for Restructuring the Economic System contracted out research projects on three-, five-, and eight-year term reforms to nine research institutes and universities. The institutes picked for the research and their representatives are as follows:

(a) The research project team for the middle-term reform at the Institute of China Economic System Reform (Cheng Xiaonong, Song Guoqing, and others)

(b) The Wu Jinglian project team at the State Council’s Economic, Technical, and Social Development Research Center (Wu Jinglian and Zhou Xiaoyuan)

(c) The State Planning Commission project team (Liu Hong and Hong Jiahe)

(d) The project team on a middle-term program on economic system reform at the Chinese Academy of Social Sciences (Liu Guoguang and Zhang Zhuoyuan)

(e) The three-, five-, and eight-years’ reform plan project team at Beijing University (Li Yining)

(f) The research group for economic system reform of the research team of the Central Party School of CPC (Wang Jue)

(g) The People’s University of China project team (Wu Shuqing)

(h) A project team at the Development Institute of China’s Rural Development Research Center (vice-director Chen Xiwen)

(i) A Shanghai System Reform Committee project team (chairman He Gaosheng)

The proposal produced by the Beijing University group suggests seven items of reform for the three phases of reform, namely, 1989–90, 1991–92, and 1993–95, as Table 4-9 shows. This proposal presented as the final reform goals the full adoption of the joint stock enterprise system, complete abolition of price control and evolution for mature financial and labor markets. Reform proposals from other institutes are by and large the same on the main items as the Beijing University design.

It is true that China had to shift to adjustment policies. At the sight of the repression of the democratization movement at Tian-anmen Western sources were afraid that the reform and open-door line might be canceled. But we should remember that the designs from all of the said nine institutes had upheld basically the same reform goals. These institutes in fact are China’s representative brain-truster groups. And they still hold influence on China’s policy making. It is therefore predicted that despite short-term policy changes that may occur with possible changes in top-leadership, China’s basic reform and open-door line will be maintained.

However, the proposed basic design is still a mere design. To come to grips with the realities, it should be mediated by more concrete and detailed policies, measures or methods. Though all the said groups agree on the goals, they differ when they come to the point of where to begin. For instance, Wu Jinglian of the State Council’s Development Research Center emphasizes the importance of price reform while Prof. Li Yining at Beijing University holds that the first priority should be given to ownership system reforms, arguing that the reform would inevitably fail if price reform should come first. Liu Guoguang, vice-president of the Chinese Academy of Social Sciences, and Zhang Zhuoyuan, the director of the Institute of Financial Material Economy, insist that reforms should be promoted in parallel in all the areas. Whatever their emphasis and priorities, however, they all lack concrete plans for implementation.

The price control for meat, vegetables, and fruit was experimentally abolished in 1985 and 1988, but on both occasions, little attention was paid to the improvement of circumstantial conditions such as distribution organizations or traffic systems relevant to these price reforms. It does not seem that serious studies were made on possible reaction of the masses to price changes as well as on social unrest that may arise in the wake of abolition of price control. Nor were there studies, to the best of my knowledge, on measures to be taken vis-à-vis such social unrest. Moreover the top Chinese leaders lacked the will and the unity to conquer difficulties and accomplish the price reform. The Chinese government should not have so easily retracted a policy which had the unanimous agreement of the entire government and bureaucratic apparatus.

The Three-stage Reform Program by the State Commission for Restructuring the Economic System

In the summer of 1991, the State Commission for Restructuring the Economic System disclosed its Ten Years’ Program Concerning Economic System Reform
<table>
<thead>
<tr>
<th>Type of Reform</th>
<th>1988–90</th>
<th>1991–92</th>
<th>1993–95</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Enterprise reform</td>
<td>(1) Contract system strengthened; all personnel to bear risks</td>
<td>(1) Transition from contract system to joint-stock system</td>
<td>(1) Transforming large and medium-sized enterprises in general industries into joint-stock companies</td>
</tr>
<tr>
<td></td>
<td>(2) Normalization of order forms</td>
<td>(2) Establishment of government assets-management organizations</td>
<td>(2) Promoting holding companies; developing enterprise groups</td>
</tr>
<tr>
<td></td>
<td>(3) Experiment with joint stock system</td>
<td>(3) Experiment with joint stock system</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(4) Promoting enterprise mergers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Agricultural reform</td>
<td>(1) Establishing a fund for standardization of agricultural products</td>
<td>(1) Establishing land banks and credit associations for land lease brokerage</td>
<td>(1) Fostering large household farms specializing in certain products</td>
</tr>
<tr>
<td></td>
<td>(2) Organizing cooperatives for transportation and marketing of agricultural products</td>
<td>(2) Aligning cooperatives for transportation and marketing of agricultural products</td>
<td>(2) Encouraging household farms to voluntarily organize &quot;agricultural, industrial, commercial, transportation, and construction combines&quot;</td>
</tr>
<tr>
<td></td>
<td>(3) Developing cultivating and harvesting agencies on behalf of peasants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Financial reform</td>
<td>(1) Changing state-owned specialized banks from institutions to enterprises</td>
<td>(1) Turning some specialized banks into joint-stock companies</td>
<td>(1) Establishing industrial and financial combinations</td>
</tr>
<tr>
<td></td>
<td>(2) Creating a dual-credit system (planned loans and market loans)</td>
<td>(2) Establishing a first and second section for stock exchange</td>
<td>(2) Liberalizing interests with government’s indirect control</td>
</tr>
<tr>
<td>(4) Trade reform</td>
<td>(1) Contract system for trading enterprises</td>
<td>(1) Turning trading enterprises into joint-stock companies</td>
<td>(1) Currency floating under administrative control</td>
</tr>
<tr>
<td></td>
<td>(2) Increasing the rate of foreign exchange retention</td>
<td>(2) Giving large and medium-sized enterprises the power to conduct foreign trade</td>
<td>(2) Independent accounting for trading enterprises</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(3) Further increasing the foreign exchange retention rate</td>
<td></td>
</tr>
<tr>
<td>(5) Fiscal reform</td>
<td>Contract system to be responsible for fiscal revenues and expenditures (fixed-amount and progressive contracts for turning over revenues)</td>
<td>Adjusting tax composition; Preparing for &quot;fenshushich&quot; (separate tax systems) for the central and local governments</td>
<td>Cutting the irregular ties between local governments and enterprises by applying the separate tax system</td>
</tr>
</tbody>
</table>

* A system under which the kind of taxes collected by the central and local governments are specified so as to draw a clear line of demarcation between central and local finances.
mapping out reforms to be carried out before the year 2000. According to the program, the reform will be three-staged.\(^5\)

The first stage, 1991–92, still strongly retains adjustment aspects, with emphasis on stable economic growth and enhancement of economic efficiency.

Central to this stage are measures to activate large and medium-sized state-owned enterprises which suffer from deteriorating business performance. As a means to achieve this goal, the contract management responsibility system should be improved and formation of enterprise groups encouraged. Also promoted are reforms in the price system, housing system, and social insurance system. In the meantime, markets for producer-goods, financial, technology, real assets and labor will be fostered while the government’s macro control on them will be reinforced.

On the second stage, 1993–95, where the scope of reform will be expanded, major reform steps will be taken.

First, “shuli fenli,” or the separation of tax from profit, will be spread far and wide. Under the existing corporate tax system, large and medium-sized enterprises pay 55 per cent of their profits in tax while small enterprises are subject to eight-scale progressive taxation. Under the newly proposed formula, the corporate taxes will be changed to a uniform 35 per cent for enterprises of all sizes. With this change, the enterprises will no longer be permitted to subtract depreciation cost of fixed capital or funds for bonuses and fringe benefits for their employees from their pre-tax revenues.

Second, “fenshuzhi,” or a separate tax system, will be introduced. This means that the kinds of taxes collected by the central and local governments will be respectively defined. This system is intended to draw a sharp line between the central and local finance and increase the central government’s share in proportion to an increase of the total amount of collected taxes.\(^5\)

Third, more and more state-owned enterprises will be turned into joint stock systems, based mainly on mutual sharing of stocks among state-owned enterprises.

Fourth, full-scale reform and open-door program will be experimentally implemented in the three provinces of Guangdong, Fujian, and Hainan.

The third stage is set for 1996–2000. The goal here is to complete a new economic management system based on organic combination of planned economy and market economy. In this period, China will about complete its transition from the old to the new system.

The final goals of the reform are the following four: first, the establishment of a unified market economic system under the government control; second, remaking the ownership structure into a fully rational structure and further activating state-owned enterprises; third, full liberalization of prices; fourth, coordination of possible various conflicts of interests (e.g., conflicts over distribution between the central and local governments, regional disparities, etc.); and fifth, improvement in, and standardization of, housing, post-retirement, and medical insurance systems.
The Future Model China Makes for

If the economic reform is carried out as designed by the State Commission for Restructuring the Economic System, China will accomplish the conversion to a almost complete market economy in the twenty-first century. As far as the institutional framework is concerned, China then will have a market economic system mostly identical with the Western system except in one crucial point. That point is that in the Chinese case, the state-owned assets management bureau will still be holding one third to half of the stock shares of the state-owned enterprises, which will remain as major economic powers in the Chinese economy. With this characteristic Chinese socialism will be demarcated from the Western conventional market economies. Table 4-10 made by Professor Riichi Tabata idealizes various economic models encompassing socialism and capitalism and shows countries roughly falling into those model categories. It can be said in reference to this table that the model the state commission prefers is a guided socialist model with state-owned and privately run enterprises.

To date, the Chinese state-owned enterprises and state-run enterprises have been almost synonymous. Now we know that China favors the guided socialist model with state-owned and privately run enterprises. But how that model is attained and how the system of this model is run is still not clear enough. A number of points should still be clarified more concretely, such as what kind of individuals or organizations will manage the state-owned enterprises after privatization of state assets, how stock transactions will be done, and how the stockholders will exercise their rights.

Figure 4-3 shows a system of state asset management as designed by Zhang Jixiang, Director of the state-owned assets management bureau which was established under the Ministry of Finance in 1988. Zhang's system has four characteristic aspects.

First, a committee is to be set up for coordination of views and interests among different central government ministries. The coordination committee is to consist of the Planning Commission, Ministry of Finance, the industrial ministries and other related ministries under the State Council.

Second, the state-owned assets are managed in the following three different ways.

1. Concerning those industries which have the tendency of monopolizing natural resources and technologies and also have a highly public or specific character, the state-owned enterprises therein are placed under the strict control of the government agencies in charge of them. For instance, government offices designated by the state-owned assets management bureau shall manage matters pertaining to the dispatch of government representatives to the enterprise management committees (board of directors), appointment of main directors, and ratification of business plans of enterprises.

2. Banks and other state-owned financial enterprises are supervised by
representatives dispatched to their management committees from the state-owned assets management bureau and the People's Bank of China. Their business plans are placed under the control of the People's Bank of China.

(3) As for general state-owned enterprises other than those in the above two categories, they are encouraged to form enterprises groups subject to multi-layered management. The state-owned assets management bureau exercises management powers over mainly the large and medium-sized key state-owned enterprises in the capacity of their owner. The bureau manages general medium and small state-owned enterprises indirectly through various holding company management committees. Generally, the performance of these state-owned enterprises are evaluated through their profit targets. The mandatory plans and contracts given to these enterprises by the government shall not prejudice their profit positions.

Third, a state investment corporation will be set up encompassing various industries to manage funds for new investment forming state-owned assets. There are three routes for managing China's fixed assets investment. As is clear from Figure 4-4, new capital construction investment (jiben jianshe touzi) used to be provided in the form of grant directly from the state finance according to the state plans (route 1). The State Planning Commission was directly controlling on the choice of projects, the decision of enterprises in charge, approving construction plans, and allocating quotas. In 1979 the formula of free provision of investment fund began to be modified in favor of interest-bearing bank loans (route 2). In 1988, a special budget for capital construction was created on an experimental basis (route 3). This last is the most important future route through which the state investment corporation induce investment of state-owned enterprises. But investment through this channel still has but a meager share in the total of investment in China. This system resembles the Japanese government loan and investment program under which savings are funneled into the private sector through public enterprises such as the Development Bank and the Housing Financial Corporation.

Fourth, the state-owned assets management bureau will create a series of reporting and information systems with proper organizational structures. Thus, the bureau will heighten its management functions with the collaboration of the Statistical Bureau, Supervisory Bureau, Administration for Industry and Commerce, Price Bureau, and the Auditing Administration.

By the way, it should not be forgotten that the above are just all medium-and long-term perspectives as proposed by Chinese administrative offices and research institutes. History has not yet known any cases that a system under which national economy was dominated by state-owned and privately run enterprises successfully functioned. Once in 1950s Chinese government had established the "joint state-private enterprises" to control the national bourgeoisie capital, but this joint state-private type was only the transitional step to nationalization.

If things go wrong, the system of "state-owned and privately run" may let the "bureaucrat capital" dominate the major part of national economy as seen in the period of the Republic of China. Taking this historical experience into consideration, there is of course no guarantee that the Chinese experiment with this model will be successful.

Although there is an agreement in China on peaceful and gradual reform at the present stage, it is possible that radical liberals may attempt to overthrow the present regime. The possibility that national independent movement may flare up has not been eliminated. Plans for gradual reform from above can easily be overthrown should such political events occur.

Summary

The market economy has its own principles that need to be followed and an order that needs to be respected. Just removing controls and liberalizing everything does not create a market economy. How to build and control a market
economy is still a difficult task facing China today. It will be a long time before China can institutionalize new economic reform measures and get them to work normally. Until such a time, the distribution in enterprises behavior will not be corrected.

Since early 1992 China has rushed into a new stage of accelerated economic reform and open-door policy. The open-door policy has been extended to inland cities from the coastal districts. Several new provisions and measures have been promulgated to remodel the management mechanism of state-owned enterprises and even to adopt joint-stock systems. However, there has been no fundamental change in the basic conditions which has made China’s economic reforms fall into difficulties. Considering the social chaos that could arise, China has to proceed cautiously and prudently in its economic reforms, trying in this process to mitigate the various contradictions and obstacles.

Notes
This chapter is based on the author’s “Chūgoku keizai kaikaku no kiseki to mujun” [The trajectory and contradictions of China’s economic reform] in Kaikaku-kaikō jidai no Chūgoku [China in the era of reform and the open-door], ed. Tatsumi Okabe and Kazuko Mōri (Tokyo: Japan Institute of International Affairs, 1991) and “Economic Reform and the Behavior of State Enterprises in China,” Developing Economies, Vo.28, No.4 (December 1990).

1 Remin ribao, October 26, 1987.
2 Dong Fureng, “Jingji yunxing jizhi de gaige he suoyouzhi de gaige” [Reform of the economic operative mechanisms and of ownership], Jingji yanjiu, 1988, No.7, pp.27–33.
3 Remin ribao, August 16, 1989.
4 Remin ribao, April 12, 1991.
7 According to Zhongguo jingji nianjian, 1989, p.IV-47, extraplan employment in 1988 totaled 10,418,000 jobs; beyond this figure, however, there are a lot of other temporary workers (Yang Yongzhong, “Zai zhili zhengdun zhong wangshan laowu shichang” [Improving the labor market by carrying out the austerity programme], Zhongguo jingji tizhi gaige, 1989, No.12, p.22).
11 See Chapter 3.
13 According to D. Granick, there is no correlation between the amount of profit earned by Chinese enterprises and the salaries and wages paid to their employees. This is because Chinese supervisory authorities have no objective criteria for assessing enterprise performance. See D. Granick, Chinese State Enterprise: A Regional Property Rights Analysis (Chicago: University of Chicago Press, 1990), pp.187–189; As I pointed out in the text, uniformly applying objective criteria would not accurately reflect excellent or poor enterprise performance when irrationalities in the pricing system prevail. Enterprise performance inevitably has to be assessed in accordance with the individual situations of given enterprises.
14 Wu Jinglian, “Jingji tizhi gaige qianli de nandian he chulu” [The hardness faced by the economic structure reform and its way out], Caizheng jingji, 1988, No.3, p.10.
15 Zhongguo jingji-nianjian-bianjian-wenyuanhui, ed., Zhongguo jingji nianjian, 1989, pp.III-1–2. According to this source, transformation of state enterprises into joint stock companies, while being an important item in the reform program, is still at a primitive stage.
18 Tian Daigui, “Zhengque renshi he pingjia chengbao jingying zerenzhi” [Correct understanding and assessment of the contracted management responsibility system], Caizheng jingji, 1988, No.4, p.56.
20 Xue Muqiao, “Guanyu jingji tizhi gaige wenti de tantao” [Tentative study on the reform of the economic system], Jingji yanjiu, 1980, No.6, pp.9–11.
33 Xu Dazhi, "Gaige yu fazhan miandian de maodun he wenti" [Contradictions and problems in the reform and development], Zhongguo fazhan yu gaige, 1989, No.8, pp.10-11.
34 Shen Liren and Dai Yuanzhen, "Woguo 'zhuhou jingji' de xing-cheng ji qi biduan he genyuan" [Formation, defect, and origin of "the economy divided by dukes or princess under emperor" in China], Jingji yanjiu, 1990, No.3, pp.15-16.
35 Qiu Qinghong and Liu Qiusheng, "Dui dangqian jingji xingshi de panduan ji shili zhengxiu de jiben duice" [The judgment of present economic situation and the basic countermeasure of administration and consolidation], Jingji yanjiu, 1989, No.12, pp.33; Renmin ribao, August 30, 1989.
39 In fact, the factory director is the champion of the employees' interests; 80 per cent of the retained profits are appropriated for bonuses and fringe benefits and only 20 per cent for productive investment (Dai Yuanzhen and Li Haoming, "Gongzi qinsheng" [Wages swallowing up profits], Jingji yanjiu, 1988, No.6, p.8.)
40 Liu Renshu and Zhou Baolin, "Qiye duanqi xingwei chuyi" [A humble study on the lirun] (Wages swallowing up profits), hngy'i yanjiu, 1988, No.6, p.8.
41 Liu Renxiu and Zou Bailin, "Qiye duanqi xingwei chuyi" [A humble study on the lirun] (Wages swallowing up profits), hngy'i yanjiu, 1988, No.6, p.8.
42 Du Haiyan et al., "Dangqian tonghuo pengzhang zhong de guoyou qiye xingwei" [The behavior of state-owned enterprise under the inflation], Jingji yanjiu, 1989, No.2, pp.41-47.
tax, bonus tax, regulatory tax on individual income and others belong to fixed revenue for the local finances. General excise tax, value-added tax, turnover tax, industry and commercial consolidated tax, taxes on the possession of resources are separate to the central and local finances. The rate of separation is eighty for the localities with twenty for the center in national minority areas and fifty-fifty in the other areas (Renmin ribao, June 20, 1992).

56 Under the envisaged new system, however, there will be a need to differentiate between the two. To overcome this difficulty, in September 1992 the Chinese leadership decided to abandon the nomenclature “state-run enterprise” and use only the term “state-owned enterprises.”

57 On May 15, 1992, several provisions including “Normal views on limited liability companies” and “Measures for trial implementation of joint-stock enterprises” were promulgated (Renmin ribao, June 22 and 16, 1992), but these contain no detailed rules and regulations for the management of state-owned enterprises under a joint-stock system. 3,220 joint-stock companies (not including the joint-stock cooperatives of township and village enterprises, joint ventures involving Chinese and foreign investment, and domestic joint ventures between different ownerships) were established by the end of 1991. Of these companies 2,751 (86 per cent) have issued stock to their own employees, while 380 (12 per cent) have adopted the holding company system and only 89 (2 per cent) have sold stock to the general public.


Conclusion

China’s Divergence from the Former Soviet Union and Eastern European Countries

The Chinese government resorted to armed repression of the Tian-anmen demonstrators in order to protect the existing regime. This violent action naturally drew strong protests and condemnation from many countries around the world, and China found itself facing economic sanctions imposed by the West. Its international isolation increased the gloomy atmosphere prevailing inside the country following the political and psychological impact of the Tian-anmen incident; and this was further accentuated by the austerity and stringent policies imposed by economic adjustment.

While repression and gloom prevailed in China, the old regimes in Eastern Europe and the Soviet Union were collapsing one after another. The Tian-anmen incident served as a negative teacher to these countries. Their leaders recognized that harsh repression like the Tian-anmen action would invite worldwide condemnation, and not a few such leaders even volunteered to join the democratization movements. Thus these movements exploded in these countries, leading even to the collapse of the Soviet regime that had lasted for more than seventy years. While the Chinese people were feeling battered and suppressed, the people in Eastern Europe and the Soviet Union were feeling inspired by the hope that they were entering a new era.

But later developments have hardly satisfied the expectations of the people of Eastern Europe and the Soviet Union. After the disintegration of the latter, the former Soviet republics have found it painfully difficult to transform their economic systems to market economies. In Russia the inflation rate reached
The former Yugoslavia, once proud of its self-managed socialism based on the principle of fraternity, has long been ripped by civil war. Even Poland which is said to have succeeded in marketizing its economy, is staggering under U.S.$45 billion in foreign debts (as of early 1991), and needs further financial assistance from abroad. Although the hyper-inflation of 700 per cent experienced in 1989 has been overcome, the price index in Poland is still rising at 40–60 per cent a year. The Polish people have suffered severely from the contradictions and conflicts inherent in the transition to a new system, and they are becoming critical of the “shock therapy” administered under the guidance of the International Monetary Fund and a number of Western economists.1

The Eastern European countries and the former Soviet Union pleased the West with their quick moves toward democracies and market economies. But they now find themselves in turmoil. Meanwhile China, which was harshly treated by the West, has enjoyed a relatively stable supply of consumer goods and shown excellent performance in its external economic relations especially with the Western countries including the United States, such as foreign trade and foreign investment. This is truly ironic.

The conversion from a one-party dictatorship to a democratic system and from a centrally controlled economy to a market economy is an historical necessity for the present stage of the former socialist countries. However, chances of success are slim if a country dashes off toward a new system without considering its own historical characteristics and social realities, and without understanding the interrelated circumstances that its old system functioned under. Legal arrangements needed for introduction of market systems can be introduced rather quickly; but it will take many years and many steps will have to be taken before such arrangements truly begin to function.

Converting an economic system is not like assembling or disassembling toys. The system is living flesh and blood. It would be futile if the patient died of exhaustion in a thorough-going and bold operation even if it is successful in other arrangements. The system is living flesh and blood. It would be futile if the patient died of exhaustion in a thorough-going and bold operation even if it is successful in other arrangements.

After the Victory of the Market Economy System

From the autumn of 1991 through the spring of the following year, China’s top party leaders and elders visited Guangdong, Fujian, and Shanghai to appeal for promotion of reform and the open-door policy. China is now heading toward the full functioning of the market mechanism. What type of market economy will emerge is still a matter of conjecture, but sooner or later the time will come when China has completed its conversion to a market economy.

This book has focused on China’s process of conversion to a market econo-
ly have an extraordinary impact on global resource distribution and environmental pollution. However, the developed countries have no right to tell developing countries to suppress their economic growth while the former continue to enjoy their current level of consumption. It is apparent, therefore, that after the market economy with its pursuit of mass production and mass consumption has conquered the whole world including Eastern Europe, the former Soviet Union, and China, the time will certainly come when the people of the world will be compelled to ask fundamental questions about this economic system and the values it rests upon.

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5 Reeitsu Kojima, “Chigoku no keizai kaikaku to kaihō seisaku (1)” [Economic reform and the open-door policy of China (1)], Ajia keizai, Vol.27, No.7 (July 1986).

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