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**THE ECONOMICS AND POLITICS OF TRANSITION
TO AN OPEN MARKET ECONOMY: CHINA**

by Wing Thye Woo

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RÉSUMÉ

La Chine est considérée comme un exemple notoire de réussite d'une approche progressive de la transition d'une économie dirigée vers une économie de marché. Ce document passe en revue le contexte initial, les étapes de la réforme et les conditions politiques préalables à la libéralisation. Selon l'auteur, cette approche graduelle est davantage le résultat de fluctuations au sein du Parti communiste chinois entre les éléments orthodoxes et ceux ouverts à la réforme, que d'un choix délibéré destiné à faciliter la transition. La libéralisation économique est considérée comme un moyen de préserver le pouvoir du Parti, quoique les opinions divergent quant au degré de libéralisation nécessaire pour atteindre cet objectif. Aussi le rythme et les orientations de la réforme dépendent-ils largement de la composition de l'équipe dirigeante du Parti à chaque période considérée.

SUMMARY

China is considered to be a particularly successful example of a gradual approach to transition from a command economy to a market economy. This paper reviews the initial conditions, the calendar of reform steps, and the political preconditions for liberalisation. It argues that gradualism was rather the result of a political balancing act between orthodox and reform-minded elements in the Chinese Communist Party than a deliberate approach towards facilitating transition. Economic liberalisation was considered as an instrument for safeguarding the power of the Party, but opinions differed on the degree of liberalisation needed to achieve this goal. Thus, the pace and the direction of the reform process were very much a function of the composition of the leadership of the Party at any given time.

PREFACE

During the 1990s, the number of countries which have embarked on fundamental economic policy reforms leading to open, competitive market economies has grown dramatically. Centrally planned economies in Eastern Europe and East Asia, as well as countries with highly interventionist policy regimes such as India or Brazil, have been eager to reduce government involvement in economic decision making, to ensure macroeconomic stabilisation, and to open up to international trade and capital flows. Based on these experiences, a considerable amount of knowledge about critical reform ingredients and the timing of their implementation have been accumulated.

Experience has also shown, however, that reforms are not always carried through, or are stalled during the reform process, due to opposing political interests. Economic reform always creates winners and losers, and frequently the losers include politically powerful groups. In 1996, the OECD Development Centre launched a research project to analyse the political preconditions for the success of economic policy reform in transitional and developing countries. The objective is to study the interplay between economic necessities and political challenges during the implementation of policy reform, thereby generating recommendations for dealing with political opposition to reform.

The project focuses on the experience of six countries: three large economies, China, India and Russia, and the smaller Colombia, Egypt and Viet Nam. The distinction between large and small countries was made because the regional dimension adds to the problems of reform in large countries, while outside influences may play an important role in small economies. The case studies, each of which is being published separately, will be complemented by a synthesis volume identifying common experiences and summarising the major policy conclusions for countries, which are latecomers in implementing reform.

China was chosen as a special case study, not only because of the size and regional diversity of the country, but also because of the gradual approach to economic policy reform adopted by successive Chinese governments. The analysis demonstrates that gradualism arose from the necessity to forge reform coalitions and was not an approach deliberately chosen by the Chinese authorities to facilitate the transition to a market economy. Such coalitions also need to be formed in other reforming countries, and hence the Chinese example provides some important insights into the political economy of reforms.

Ulrich Hiemenz
Director
OECD Development Centre
October 1999

I. INTRODUCTION

China is now on the cusp of even greater socio-economic changes than it has experienced in the last 19 years. At the 15th Congress of the Chinese Communist Party (CCP) held in September 1997, the CCP made the historic decision of undertaking large-scale privatisation of the state sector under the rubric of “diversifying the ownership structure”. Although no timetable was announced, this statement should be seen as a serious attempt to fulfil the pledge that the CCP made at the 14th Party Congress five years earlier to create a socialist market economy with Chinese characteristics. It is currently accepted that socialism with Chinese characteristics means the abandonment of “state socialism” for “people’s socialism”, and that “people’s socialism” is analytically hard to differentiate from “people’s capitalism”.

China achieved the impressive average annual growth rate of 9.9 per cent between the start of its market reforms in 1979 and the announcement of sweeping privatisation in 1997. This successful growth performance, perhaps the highest in the world during this period, has dramatically transformed China’s economic structure. The proportion of the labour force engaged in agriculture dropped from 71 per cent in 1978 to 51 per cent in 1996, and the proportion of gross industrial output produced by state-owned enterprises (SOEs) declined from 82 per cent to 26 per cent in the same period¹. The integration of China into the world economy has been equally dramatic: trade (exports plus imports) rose from 10 per cent of GNP in 1978 to 36 per cent in 1996, and direct foreign investments was \$45 billion in 1997 compared to \$2 billion in 1983. Human development indicators, including life expectancy, literacy, infant mortality, per capita income, and the incidence of poverty, all show a dramatic improvement, in line with the rapid economic growth.

China’s rapid growth performance presents various paradoxes that have become the subject of heated debate within the economics profession. Why is it that a country that espouses socialist practice is among the fastest growing countries in the world, when virtually all other socialist economies have collapsed? While there is little disagreement about the role of market reforms in spurring China’s rapid growth, there is strong dispute about the character of those reforms. Have they been gradual or rapid? Has the gradualism been a source of success, or a hindrance? Are the non-market aspects of China’s economy, such as the large state ownership that persists till today, a source of potential instability in the years ahead? What lessons, if any, does China’s experience offer for other countries in the transition from central planning to a market economy?

Interpreting China’s Growth

Broadly speaking, two schools of thought have emerged to interpret the Chinese experience — the Experimentalist school (E-school), and the Convergence school (C-school)². The Experimentalist School of thought gives great credit to the evolutionary, experimental, and incremental nature of China’s reforms. A faster approach to reforms, like the one implemented in Poland, according to the E-school, would have led to more social conflict, instability, and poorer economic policies (because of less experimentation).

The conclusions of the E-school were derived by working backwards from China's impressive growth to the partial economic deregulation that was implemented on many fronts, and identifying the *deus ex machina* of the incremental reform strategy to be the "ex-post coherence of Chinese reforms". Specifically, China's seemingly disparate reforms have generated high growth because incremental experimentation has unleashed an unintended virtuous cycle:

"After fifteen years, it is clear that there is substantial ex-post coherence to the Chinese reform process. It should also be clear that this coherence is not the result of a carefully plotted reform strategy. Indeed, during some crucial periods, the coherence of the reform process emerged in spite of, not because of, the policies of the Chinese leaders. Coherence was a characteristic of the economic environment in which the transition path unfolded, rather than of the explicit choices of policymakers ... There are certain critical, or core, features of the command economy, and once these are eliminated or weakened, the system has a tendency to devolve into another type of system. Provided there is some political will to move the system in the direction of a market economy during this dissolution process, a positive process of transformation may be set into motion even without a clear or comprehensive commitment to a reformed market economy at the outset."³

Specifically, the E-school proposes that China's experiments in non-capitalist institutions are proving to be successful in *a*) agriculture where land is still state owned; *b*) township and village enterprises (TVEs) that are owned collectively by rural communities; and *c*) state owned enterprises (SOEs). The E-school, in short, interprets China to be evolving towards a unique set of economic institutions, as a result of experimentalism in policy design; and proposes that other transition economies should emulate China's experimentalism and initiate their own country-specific virtuous cycles.

The Convergence school (C-school) rejects the E-school's perception of alleged ex-post coherence in China's reform process as a fallacy, and holds the E-school to be guilty of *post hoc, ergo propter hoc*. The C-school holds that China's successes are the consequences of its institutions being allowed to converge with those of non-socialist market economies, and that China's economic structure at the start of reforms is a major explanation for the rapid growth. The C-school dismisses "policy experimentation" as the primary explanation for China's gradualism, and it recognises the primary explanation for gradualism to be the lack of political consensus over the proper course, with power still divided between market reformers and old-style socialists, and the "innovative" non-capitalist institutions lauded by the E-school to be responses to China's political circumstances and not to its economic circumstances.

Specifically, the C-school proposes that favourable outcomes have emerged not because of gradualism, but despite gradualism⁴. China has achieved the greatest success in precisely the areas (e.g. agriculture and coastal provinces) where market reforms have gone the furthest. Moreover, China has benefited from its economic structure, including a high population density (as in the rest of East Asia) that is favourable for labour-intensive, export-led growth. According to the C-school's reading of the evidence, China's experiments in non-capitalist institutions have not been unsuccessful in *a*) agriculture; *b*) rural industry; *c*) state industry, and that these sectors need further reform towards more typical capitalist institutions.

Sachs and Woo (1997) summarise the differences in outlook across the two schools of thought in Table I.1.

Table I.1. The Experimentalist School and the Convergence School

	Experimentalist School	Convergence School
Speed of reform	Sequential trial-and-error	Rapid and comprehensive liberalisation of agriculture, and of international trade in coastal provinces; slow deregulation of SOEs and of international trade in interior provinces
Reasons for gradualism (incrementalism)	Economic experimentation	Political compromise; ideological commitment to state ownership
Sources of rapid growth	Unintended virtuous cycle, and little dislocations from large shifts in policies	Existence of surplus agriculture labour; East Asia pattern of labour-intensive export-led growth
Outcomes in the SOEs	Substantial improvements in production efficiency	Little technical progress; and over-compensation of SOE personnel and over-investment that weaken the fiscal situation
Interpretation of the TVEs	Adaptations to China's economic conditions of still-developing markets	Continuing legal restrictions on private ownership
Future directions and pace of reform	Policies will change to reflect evolution in material conditions and lessons from continuing experiments	Policies will push China toward a normal private market economy with characteristics similar to other East Asian economies

The fact that the 15th Party Congress decided to convert most of the SOEs to shareholding corporations appears to support the Convergence school's view of China's economy.

Important Turning Points in Policy Making

There were four key turning points in economic policymaking in the 1978-1997 period. The first was at the end of 1978 when the CCP agreed to limited deregulation of the agricultural sector. The second was in 1984 when the CCP approved the extension of the contract responsibility system from the agricultural sector to the industrial sector. The third was in 1988, which marked a transition in the economic policy making leadership from market-oriented reformers to plan-oriented conservatives. The fourth turning was in 1992, in the wake of the implosion of the Soviet Union, when Deng Xiaoping mobilised overwhelming pressure from the provinces to commit the party successfully to building "a socialist market economy with Chinese characteristics".

The First Turning Point

The most important of the four turning points occurred at the Third Plenum of the 11th Party Congress in December 1978⁵. It marked the beginning of a rapid rejection of the leftist economic programme of Mao Zedong, which was dedicated to egalitarianism enforced on the bulk of the population through large agricultural communes, and dedicated to ideological purity enforced by basing promotions on being “red” in political orientation rather than being “expert” in economic management. Mao’s leftist programme had caused big gyrations in output, and much human suffering in the period of the “Great Leap Forward” economic strategy. National income (according to the soviet definition) grew 22 per cent in 1958 but plummeted 30 per cent in 1961, causing 30 million Chinese to die of starvation; see Table I.2.

At the Third Plenum, Deng Xiaoping successfully led a coalition of central planners and market reformers to force the reigning Maoists under Hua Guofeng to significantly relax the degree of collectivisation in the agricultural sector, raise the prices of agricultural products, introduce some material incentives in the industrial sector, and establish special economic zones (SEZs) in the southern coastal provinces to attract foreign direct investment. The economic deregulation and opening had to be partial in nature not only because of the necessity to appease the Maoist beliefs in co-ordinated group effort, political exhortations, and self-sufficiency, but also because of the necessity to keep the reform coalition together. The central planners in Deng’s coalition also believed in autarky.

The theme of the economic programme presented by Deng’s reform coalition was the fulfilment of the Four Modernisations (modernisation of agriculture, industry, science and technology, and defence)⁶ carried out in the line with the Four Cardinal Principles of (1) the socialist path, (2) the dictatorship of the proletariat, (3) the leadership of the CCP, and (4) Marxist–Leninist–Mao Zedong Thought. This theme was designed to send three messages to the rank and file of the party. First, the political legitimacy of the party should be based on economic construction alone, as evidenced by the absence of mention of political modernisation. Second, leadership of the party should go to those who could deliver good economic performance. Third, the economic reform programme would not only maintain the ideological purity of the party but also its political supremacy in the country.

The agricultural reforms were a great success. Per capita income in the rural areas increased by an average of 14.6 per cent in real terms from 1978 to 1984. The agricultural boom contrasted sharply with the shortages in the agricultural sector created by Guofeng’s “Great Leap Outward” programme of massive investment in heavy industries and infrastructure. The party faithful, persuaded by Deng’s urging that leadership belonged to those who were capable of delivering the economic performance that would legitimise the rule of the party, ousted Hua and most of the remaining Maoists in 1981.

Table I.2. **China: Output and Price Fluctuation, and Money Growth**
(percentages)

Year	Real National Income (Soviet definition)	Index	Real GDP	M1	M2
1952	n.a.	-0.4			
1953	14.0	3.4			
1954	5.8	2.3			
1955	6.4	1.0			
1956	14.1	0.0			
1957	4.5	1.5			
1958	22.0	0.2			
1959	8.2	0.9			
1960	-1.4	3.1			
1961	-29.7	16.2			
1962	-6.5	3.8			
1963	10.7	-5.9			
1964	16.5	-3.7			
1965	16.9	-2.7			
1966	17.0	-0.3			
1967	-7.2	-0.7			
1968	-6.5	0.1			
1969	19.3	-1.1			
1970	23.3	-0.2			
1971	7.0	-0.7			
1972	2.9	-0.2			
1973	8.3	0.6			
1974	1.1	0.5			
1975	8.3	0.2			
1976	-2.7	0.3			
1977	7.8	2.0			
1978	12.3	0.7	11.7	0.1	3.6
1979	7.0	2.0	7.6	58.8	49.2
1980	6.4	6.0	7.8	24.7	25.9
1981	4.9	2.4	5.3	17.1	18.3
1982	8.2	1.9	9.0	10.6	14.6
1983	10.0	1.5	10.9	17.5	19.7
1984	13.6	2.8	15.2	40.1	32.6
1985	13.5	8.8	13.5	***	***
1986	7.7	6.0	8.9	27.9	30.2
1987	10.2	7.3	11.6	18.5	25.3
1988	11.3	18.5	11.3	20.0	20.7
1989	3.6	17.8	4.1	6.3	18.7
1990	5.1	2.1	3.8	20.1	28.9
1991	7.7	2.9	9.2	28.2	26.7
1992	15.4	5.4	14.2	30.3	30.8
1993	15.1	13.2	13.5	***	***
1994	n.a.	21.7	12.7	26.2	34.5
1995	n.a.	14.8	10.5	16.8	29.5
1996	n.a.	6.1	9.6	18.9	25.3
1997	n.a.	0.7	8.8	22.1	19.6

- a. National Income series was from the 1992 and 1994 issues of China Statistical Yearbook. Series was discontinued after 1994.
b. Retail Price Index was from 1992 China Statistical Yearbook, and the People's Bank of China Quarterly Statistical Bulletin, 1998-I.
c. Real GDP was from 1997 Almanac of China's Finance and Banking, and the People's Bank of China Quarterly Statistical Bulletin, 1998-I.
d. Definitions of M1 and M2 were changed in 1986 and 1993.

There was, of course, more to the ousting of Hua Guofeng than to the fact that his economic programme was less successful than Deng Xiaoping's. After all, Mao Zedong not only survived the failure of the Great Leap Forward, but also went on to purge the economic team that engineered the spectacular recovery from that disaster. Deng and his allies had been courting the provincial delegates' votes since 1979 by proposing decentralisation of the fiscal system. Beginning in 1980, the centralised fiscal system where the provinces handed in all their revenue to the central government, and received allocations to fulfil their centrally assigned expenditure, was replaced by a system of revenue sharing characterised by the province-specific marginal tax rates. Under the revenue-sharing system, if the tax revenue of a province were to increase rapidly because of accelerated economic growth, then the province would keep the bulk of the revenue increase. Besides revenue sharing, the provinces were also given more discretion over their expenditure, and more authority to approve investment projects within their provinces.

The economic goal of revenue sharing and administrative decentralisation was clearly to encourage the provincial governments to promote economic development. The political goal was also equally clear, to buy votes of the provincial delegates. Tying fiscal decentralisation to the fate of Deng's reform coalition was truly a masterstroke. Susan Shirk (1993) has described this political strategy of the reformers as "playing to the provinces".

From 1981 to 1991, the chief economic policy debate was between the central planners under Chen Yun and the market reformers, first, under Hu Yaobang, and then under Zhao Ziyang. (These two groups have been called conservative reformers and liberal reformers respectively in the literature⁷.) While Deng Xiaoping was generally on the side of the market reformers, he was also the adroit adjudicator of disputes between the two groups. In many important disputes, Deng would support the economic liberalisation proposals advanced by the market reformers, and, at the same time, would support the political campaign launched by the central planners as the indirect means to undermine the moral authority of Yaobang and Zhao Ziyang e.g. the anti-bourgeois liberalism campaign in 1981, and the anti-spiritual pollution campaign in 1983.

The Second Turning Point

The second key turning point in economic policy making came in 1984 when the CCP initiated urban reforms, which was essentially reform of the SOE sector. The term "urban" was used because all the SOEs were located in the urban areas, and they employed the bulk of the urban labour force. The SOE reform package reflected the political compromise between the two groups that the plan was the primary mechanism for allocating resources, and the market was the supplementary mechanism. The new party line issued in 1984 was that the reform objective was "a socialist planned commodity economy" — heavy ideological qualifications on the "commodity economy" which is the Marxist code word for capitalist economy.

The SOE reform strategy had two key components. The first was to deregulate prices partially through a dual-price structure e.g. the state would supply some input at a low plan price, and the enterprise would have to buy the rest in the free market for inputs. The second component was to decentralise some decision-making powers to the enterprise managers.

It is actually a serious mischaracterisation of the 1984 reforms to call them “urban reforms” as official Chinese publications, and most of the Western literature have done. The qualifier “urban” deflects attention from the most important development phenomena in China in the 1980s — the explosive birth of rural enterprises. In 1984, the government greatly relaxed the regulations governing the establishment of rural enterprises and their operations in order to prevent rural migration. The result was a tremendous transformation of the Chinese economy that was unexpected by the policy makers. Deng Xiaoping confessed in 1987 that “What took us by surprise was the development of township and village industries... This is not the achievement of our central government”⁸.

The literature on TVEs is confusing and contradictory, and there are many reasons for it. The official definition of TVE has changed over time, the ownership characteristics of TVE differed across the regions and have mutated overtime, and most private rural enterprises have deliberately mis-registered themselves as collectively owned. The primary reason for the wide variety of TVE forms is the heavy legal discrimination against non-collective TVEs based on ideological aversion to private ownership. The diversity reflects the fact that socialist notions differ across regions and that this adherence has fluctuated with changes in the political climate in Beijing.

While the TVE sector flourished under government neglect, the SOE sector floundered despite the steady transfer of decision-making powers to the managers, and the massive injection of funds to upgrade technology. The high investment spending of the SOEs enabled by credit expansion generated high (by historical standards) inflation, and the dual-price mechanism created rampant inflation. The results of both outcomes were student demonstrations, and questions on the competence of Hu Yaobang and Zhao Ziyang as economic managers. The liberal faction was in serious political trouble at the end of 1986 because the party elite was particularly concerned about a Polish-style uprising developing from the student unrest.

The Third and Fourth Turning Points

Hu Yaobang was fired from his post as general secretary in January 1987, and Zhao Ziyang was stripped of any role in economic management in August 1988. The third turning point was the assumption of power by the conservative faction. The public show of support for the liberal faction at the death of Hu Yaobang in April 1989 ended in the Tiananmen Square tragedy on 4 June. The slower economic growth, escalation of losses by SOEs, and the collapse of communism in Eastern Europe reduced the credibility of the economic programme of the conservative planners.

The fourth turning point was Deng Xiaoping’s inspection tour of the southern coastal provinces (*nanxun*) in January 1992 when he pronounced that the use of capitalist tools was compatible with socialism, and that China faced greater dangers from leftism than from rightism. Alluding to the end of communism in the Soviet Union, Deng warned that the continued rule of the party was linked to the party’s ability to generate high economic performance, and high growth required more major economic reforms. The outpouring of support for Deng’s call for economic reforms marked the end of the economic programme of the conservative faction. The momentum unleashed by the 1992 resumption of market reforms culminated in the party’s decision in 1997 to use the shareholding system to restructure the state sector, an action which represented a historic turning point in China’s long march to a normal market economy.

Structural Transformation of China's Economy

Table I.3 shows the structural characteristics of the economy at, or on the eve of, each of the four turning points discussed in the previous section. There have been three major structural shifts. The first is the decline in the importance of the agriculture sector. The drop in the agriculture share of GDP dropped from 39 per cent in 1978 to 18 per cent in 1996 was mostly taken up by the rise in the industry share from 38 per cent to 54 per cent. This almost offsetting movement in output share is typical of the process of economic development where labour leaves low productivity agricultural jobs for high productivity industrial jobs.

On the other hand, the 20-percentage point drop in agriculture's share of labour employment in the 1978-96 period was mostly absorbed by the 14-percentage point increase in the service sector's share. This offsetting shift in labour employment is quite typical for a transition economy; it demonstrated the suppression of the service sector by central planning in the pre-1979 period. In short, the structural shifts in output composition and labour employment reflected the unleashing of economic development and economic transition by the marketisation of China's economy.

The second major structural transformation is the radical diversification of ownership structure⁹. The proportion of industrial output produced by the state sector dropped from 82 per cent in 1978 to 26 per cent in 1996, while the proportion produced by collectively-owned enterprises (urban and rural) and individually-owned enterprises rose from 18 per cent to 55 per cent¹⁰. Furthermore, by 1996, the TVEs were employing a larger proportion of the labour force than the SOEs, 20 per cent and 16 per cent respectively.

The third major structural transformation is the trade orientation of the economy. Exports increased from 5 per cent of GDP to 18 per cent over the 1978-96 period. Most noteworthy is the fact that TVEs accounted for almost half of the exports in 1996.

This paper is organised as follows. Section II lays out the Maoist historical background to the initiation of economic reform in late 1978. Section III discusses the politics of the economic reform. Section IV describes political factors that have interacted with economic factors to produce the evolution of ownership reforms in the SOE sector and in the collectively owned rural enterprises. Section V presents the main conclusions.

Table I.3. **Structural Characteristics of the Chinese Economy at Key Turning Points**

	Year	Composition of GDP, %			Composition of gross industrial output, %			
		Primary sector	Secondary sector	Tertiary sector	State owned	Collective owned	Individual owned	Other
Eve of economic reform	1978	38.9	37.5	23.7	82.0	18.0	0.0	0.0
Start of SOE reform, and relaxation on TVE sector	1984	35.2	37.2	27.6	73.1	25.8	0.2	0.9
Transition to management by conservative faction	1988	26.5	42.1	31.5	59.1	34.2	4.2	2.5
Eve of Deng's <i>nanxun</i>	1991	25.4	43.4	31.2	51.7	36.7	5.9	5.7
Eve of diversification of ownership structure of SOEs	1996	18.0	53.8	28.1	26.2	40.5	14.4	18.9
		Allocation of labour force, % of labour force			Export orientation			
	Year	Primary sector	Secondary sector	Tertiary sector	State owned	Township Village owned	Total export as of GDP	TVE export as of total export
Eve of economic reform	1978	70.5	17.4	12.1	18.6	7.0	4.6	n.a.
Start of SOE reform, and relaxation on TVE sector	1984	64.0	20.0	16.0	17.9	10.8	8.1	n.a.
Transition to management by conservative faction	1988	59.3	22.4	18.3	18.4	17.6	11.8	15.2
Eve of Deng's <i>nanxun</i>	1991	59.7	21.4	18.9	16.5	14.8	17.7	17.5
Eve of diversification of ownership structure of SOEs	1996	50.5	23.5	26.0	16.3	19.6	18.3	47.8

Note: Ratios for composition of GDP and gross industrial output were computed using 1990 prices.

II. THE MAOIST BACKGROUND TO THE POST-1978 REFORMS

History casts a long shadow. It casts a long shadow because it bequeaths a particular set of institutions and a specific distribution of money and power, conditions the information set that the actors draw upon, and establishes the precedents that informally govern political interaction among the actors. It will be argued that the shadow cast by history was particularly long in China on the eve of its economic reform in 1978. Maoist economic policies had created two severe national traumas that seared the national consciousness, and sowed the seeds for subsequent attitudinal changes on the central plan, state ownership, political order, and international relations. The two national traumas are the Great Leap Forward of 1958-62, and the Great Proletarian Cultural Revolution of 1966-76. The Great Leap Forward starved 30 million Chinese to death; and the Cultural Revolution decimated the administrative structures of the party and the government, and plunged the country into a big witch-hunt. Fairbank (1987) estimated that the Cultural Revolution purged 30 per cent of party officials, and 75 per cent of the top economic officials; and persecuted more than 700 000 people, of which about 35 000 died.

Economic policy making before 1979 was guided by four principles: common ownership to achieve egalitarianism, mass mobilisation to increase production efforts, centralisation to co-ordinate production, and self-sufficiency to promote industrialisation and cut dependency on capitalist and revisionist countries. The Great Leap Forward and the Cultural Revolution were the results of over-emphasis on the common ownership and mass mobilisation principles.

Overview of Top Personnel Changes

One quick way of showing the turbulence of the 20 years preceding 1979 is to highlight the frequent big changes in the membership of the Standing Committee of the Political Bureau (Politburo) of the Chinese Communist Party (CCP). The focus on individuals is not meant to suggest in any way that the path of China's economic reform has been determined solely, or even mainly, by personalistic factors. While Mao Zedong definitely influenced, and at many times dominated, policymaking in the period from 1949 to 1976, there was also substantial political logic behind the broad course of the events during the 1949-76 period that was driven by conflicting group interests, and competing conceptions of how to best develop China.

The analysis starts with highlighting the individuals rather than with discussing the broader historical and political forces that frame the incentives and constraints faced by these individuals in order to avoid retrospective determinism. One theme that runs through this paper is that the events that actually happened needed not have happened. In almost all cases, economic and political interests did provide strong incentives to favour particular policy choices, but given that everyone's preference and estimate of the uncertainty surrounding the expected outcome can differ, the realised policy find individual choice.

Table II.1 shows the composition of the membership of the Standing Committee at the end of the 8th Party Congress in September 1956, at the end of the 9th Party Congress in April 1969, after the death of Mao Zedong in September 1976, and at the end of the 3rd Plenum of the 11th Party Congress in December 1978. In the next section, it will be shown how the different interest groups and different economic programmes are represented through the different members on the various Standing Committees.

Table II.1. **Membership of the Standing Committee of the Politburo of the Chinese Communist Party¹¹**
(listed according to rank in the Committee)

After the 8th Party Congress in September 1956: Mao Zedong, Liu Shaoqi, Zhou Enlai, Deng Xiaoping, Zhu De, and Chen Yun

After the 9th Party Congress in April 1969: Mao Zedong, Lin Biao, Zhou Enlai, Chen Boda, and Kang Sheng

After the death of Mao in September 1976: Hua Guofeng, Wang Hongwen, Ye Jianying, Li Desheng, Zhang Zhongqiao, and Jiang Jing¹²

After the 3rd Plenum of the 11th Party Congress in December 1978: Hua Guofeng, Ye Jianying, Deng Xiaoping, Li Xiannian, Chen Yun, and Wang Dongxing

The 1956 membership was elected at the first post–victory congress of the CCP. The ranking member of the Standing Committee was Mao Zedong, the Chairman of the Party. The second ranking member was CCP Vice–Chairman Liu Shaoqi who was the President of the country, and also Mao’s chosen successor. Zhou Enlai was the Prime Minister, the person responsible for the working of the government. Deng Xiaoping was the General Secretary of the Party and a vice–premier. Chen Yun was a vice–chairman of the Party, and a vice–premier in the government, and he was recognised for his expertise on financial and economic matters. Even though only Marshal Zhu De held a military position, the rest of the Standing Committee were veterans in the wars against the Japanese and the Kuomintang Party, and had very close ties with the army.

Roughly speaking, Liu Shaoqi, Zhou Enlai, Deng Xiaoping and Chen Yun were the “organisation men” representing the (civilian) party and state bureaucracies. The fact that the army representative, Marshal Zhu De, ranked fifth in the Standing Committee clearly showed that the party was definitely in control of the “gun”. The overall policy orientation of this Standing Committee was towards economic reconstruction implemented through Soviet–style central planning. It is hard to characterise policy divisions within this Standing Committee because the “emperor” culture was very much in evidence — Mao had disproportionate influence on the decisions of the Committee.

Only one member (Premier Zhou Enlai) of the four “organisation men” remained in the 9th Standing Committee elected in April 1969. The Cultural Revolution was in full swing. Lin Biao, the head of the army, was the second ranking member of the Standing Committee, and the newly designated successor to Mao. Lin Biao was the editor of a collection of Mao’s sayings¹³, the famous “Little Red Book”, that became the bible of the Red Guards — the shock troops that Mao used to attack his colleagues. Kang Sheng was the head of the secret police, and Chen Boda was formerly Mao’s secretary. The important point about the changes in the Standing Committee is that Mao’s rule had become more imperial and personalistic, and one result was that the party had become more dependent on the military and security apparatus.

At the beginning of the Cultural Revolution, Mao used his wife, Jiang Jing, as a channel to attack his political enemies. Over time, Jiang Jing and three close collaborators (Wang Hongwen, Zhang Chunqiao and Yao Wenyan) came to represent the most radical aspects

of Mao's political philosophy (which could be summarised as "politics in command of everything"). Mao, once in a moment of pique, had described them as a "Gang of Four", a term that was used by their enemies after their political downfall in 1976.

With the worsening of economic conditions, the death of Lin Biao in September 1971 after the failure of his plot to assassinate Mao, and the declining health of Premier Zhou Enlai, Mao Zedong re-appointed Deng Xiaoping as vice-premier in March 1973. In January 1975, Deng was elected to the Standing Committee, and re-appointed vice-chairman of the party. Deng was dismissed (for the second time) from his party and government posts after the Tiananmen riots in April 1976. Mao died in September 1976.

The ranking member of the Standing Committee in September 1976 was Hua Guofeng, a relative newcomer with no clear constituency within the party, the government or the army. Hua was the head of both the party and the government; he was the party chairman as well as the Prime Minister. Hua was selected by Mao to be the Prime Minister in January 1976 as the compromise candidate between Deng Xiaoping who had the support of the administrative cadres and Wang Hongwen who had the support of the radical leftists. On his deathbed, Mao had designated Hua to be his successor with the now famous comment that: "With you in charge, I am at ease".

The Standing Committee was dominated by two groups: the radical leftists represented by Jiang Jing, Wang Hongwen and Zhang Zhongqiao, and the army represented by Ye Jianying and Li Desheng. The composition reflected the turmoil that the country had gone through in the Cultural Revolution over the previous ten years. There were two army generals because the army was the only institution that had a strong national network under centralised control. The army was enforcing the rule of Mao over the competing political factions. Army commanders had assumed effective party leadership in many regions. In effect, the "gun" was in effective command of the party outside Beijing.

Within a month of Mao's death, the army arrested the Gang of Four. Deng Xiaoping was restored to all his former posts in July 1977. The Third Plenum of the 11th Central Committee held in December 1978 launched China's market-oriented reforms. The Third Plenum also re-elected to the Standing Committee, Chen Yun, who was a member of the 1956 Standing Committee. Hua Guofeng remained the ranking member of the Standing Committee. The two factions within this Standing Committee were the Maoists (Hua Guofeng, Wang Dongxing, Ye Jianying and Li Xiannian) and the rehabilitated cadres (Deng Xiaoping and Chen Yun).

The First National Trauma: Havoc in the Countryside

The Mao period was one of frequent reversals in political fortunes and economic policies. An example of the latter was the treatment of the agricultural sector. Land was distributed to the peasants in the post-liberation euphoria of 1949-52. However, private ownership of land was not to last. Private ownership contradicted the CCP's, particularly Mao's, commitment to egalitarianism and common property.

The process of imposing socialist welfarism in the countryside took the form of gradually combining the production units in order to equalise the income received by the rural population. The amalgamation process began first with the formation of co-operatives in 1954-55 consisting of several households, followed by the establishment of, usually village-level collective farms in 1956-57, and finally the grouping of several collective farms into

People's Communes in 1958. Communes could be quite large, the largest commune was in Henan province and it encompassed an entire county. This termination of household farming, the basis of Chinese society since time immemorial, was completed quickly in spite of the reservations expressed by some members of the 1956 Standing Committee, but Mao was the first among equals, and his word carried the day¹⁴.

Mao crowned his land-agglomeration achievement by following up with the Great Leap Forward programme of crash industrialisation in May 1958. To catch up with the capitalist West, the party announced that steel production in 1958 was to be double that of 1957 level, which was 5.35 million metric tonnes. Backyard steel mills sprang up all over rural China, drawing labour from agricultural production, melting down farm and cooking implements to make steel, and deforesting the land for the required fuel.

The Four Economic Principles in Decision Making

The politics and economics of agricultural collectivisation and crash industrialisation came primarily from the institutional dynamics of the victorious Chinese Communist Party (CCP). The CCP leadership had mobilised their followers to patiently endure and diligently pursue the drawn-out war against the Kuomintang by preaching a utopian and moral vision of China after a Communist victory. The spoils of war could have been a primary motivation for many members of the CCP, who were landless peasants and had nothing much to lose, but this selfish motivation does not in any way preclude the commitment that these brutalised peasants had in building a more moral social system.

To put it in another way, an important reason for the CCP's ability finally to triumph in the protracted civil war was that the CCP had established credibility in the eyes of its members and in the eyes of the general public that its leadership were committed to a socio-economic and political programme that would generate a strong, prosperous and moral China — a China that could stand up to the world that had repeatedly violated its sovereignty. It would be overly cynical not to believe that the top leadership of the CCP in 1958 was fully committed to realising the Communist programme that it had been preaching.

The writings of Mao Zedong, the chairman of the CCP, constituted the most articulate and comprehensive statement of the party's programme. In fact, given the CCP's need during the civil war to provide a focal point for its organisational work, the party's constitution adopted in 1945 specified that all of the work of the party would be "guided by the thoughts of Mao Zedong"¹⁵. The economic programme of the party in 1958 was based on four principles: common ownership, mass mobilisation, centralisation and self-sufficiency.

The common ownership principle is the heart of communism. Common ownership is believed to be the ultimate moral state that society has been evolving ineluctably towards. It is regarded as the most effective means of generating income equality. More than morality and inevitability, a classless society is assumed to guarantee social harmony, hence allowing an economy to maximise capital accumulation and to ensure its full use. Common ownership is thus the moral objective to be attained as well as a means of transforming China into a cornucopia.

The mass mobilisation principle is the logical culmination of the guerrilla warfare strategy that put the CCP into power. Mao Zedong viewed "mass mobilisation" to be the most effective method of implementing economic reconstruction, using China's abundant labour power to

compensate for its scarcity of capital and energy. Mao's essay "The Foolish Old Man and the Mountain", which preaches that diligence and perseverance could overcome all, comes close to putting mass mobilisation as the equivalence of mind over matter. As a matter of fact, Mao, himself, regarded mass mobilisation to be a goal in itself. To Mao, mass mobilisation meant mass political participation — the only guarantee for egalitarianism against revisionism being imposed by bourgeois elements in the party leadership. The mass mobilisation principle in fact means putting "politics in command" of economic work.

The centralisation principle is borrowed from the Soviet Union. It replaces the political market place with democratic centralism, and the economic marketplace with central planning. In 1958, it was still possible to believe that administrative allocation was superior to market allocation. The market mechanism was suspect on ideological and economic grounds: Lenin and Stalin had equated the market with capitalism, and memories of the global Great Depression were still strong. Central planning appeared awesomely impressive in 1958: the Soviet Union had industrialised at neck-breaking speed, and it had beaten the United States in putting a satellite into space. In practice, the general plan emphasises investment over consumption, heavy industry over light industry, industry over agriculture, and agriculture over services. Soviet economic theory considers "services" to be so unproductive that most of them are not included in the socialist measure of total output, Net Material Product.

The self-sufficiency principle was partly a matter of choice, and partly a matter of necessity. The forces within China severely to limit its dependence on the outside world were ideological and historical in origin. Standard Marxist economic theory instructed the CCP that international trade should be allowed only to finance the import of goods that a country was incapable of producing, e.g. the import of tropical fruits by a temperate country. More important, perhaps, was that China's negative experiences with the capitalist countries in the preceding one hundred and fifty years had encouraged xenophobic tendencies that helped to translate political nationalism into economic nationalism¹⁶.

However, even if China had chosen to integrate fully into the world economy, it would have been prevented from doing so. The self-sufficiency principle was becoming more of a necessity. In the wake of the Korean War (1950-53), the United States had strengthened its efforts to discourage its Cold War allies to limit trade and investment in China. In the wake of Khrushchev's denunciation of Stalin (whom Mao put in the rank of Marx, Engels and Lenin in the socialist pantheon of heroes) in 1956, and in the wake of Soviet refusal to honour its 1957 pledge to transfer nuclear technology to China, Sino-Soviet relations were unravelling in 1958. The Soviet Union was no longer a reliable, or desirable, trade and military power. The Soviet Union had lapsed into "revisionism" (with the appearance of a new ruling class consisting of party cadres, government functionaries, and enterprise managers)¹⁷ and "imperialism" (with the 1956 invasion of Hungary)¹⁸.

The programmes of agricultural collectivisation and crash industrialisation were the practical implementations of the four principles of socialism, mobilisation, centralisation and self-reliance. The agricultural communes represented socialism in the countryside, and were convenient command modules to execute central planning. The Great Leap Forward strategy for industrialisation used mass mobilisation, one, to substitute for foreign capital and foreign technology, and, two, to try to leapfrog the pre-requisite of an agricultural revolution to release labour and generate surpluses for industrial investment.

The Consequences of Mao's Economic Programme

During the crash industrialisation programme, the Chinese fell into the same trap as the Russians, emphasising quantity targets at the expense of quality improvements, with the unfortunate result that a large part of the final steel products was too low grade to be usable. The negative incentive effects from the collectivisation of land, and the drawing of resources away from agriculture caused a calamitous decline in agricultural output. Over 30 million people starved to death in 1958-61, and cannibalism was common in some provinces¹⁹.

It must be mentioned that the deleterious effects of the People's Communes and the Great Leap Forward appeared very soon after their implementation. On the eve of the Central Committee meeting in Lushan in August 1959, all the key participants had read secret reports about the appearance of food shortages²⁰. Nevertheless, when Defence Minister Peng Dehuai stood up and accused Mao of incompetence, the other Central Committee members (including Liu Shaoqi and Chen Yun²¹) voted to censure Peng for damaging the party's integrity with falsehoods²². The party continued the disastrous collectivist agricultural and irrational industrialisation policies for two more years because any unduly hasty policy reversal would support the veracity of Peng's charges and expose the incompetence of the party²³.

The condemnation of Peng Dehuai by the Central Committee was due to more than Mao's grip on the personal loyalty of his colleagues. They recognised that a successful political assault on Mao by Peng Dehuai would merely mean the replacement of one powerful leader by another powerful leader, with no more power sharing than before. Worse yet, the dismissal of Mao alone would raise questions on why the leading members of the Central Committee went along with Mao's policies. There was certainly enough blame to taint the entire leadership. Thus the Central Committee voted to censure Peng Dehuai, knowing that it could use this large-scale disaster to force Mao to retreat from day-to-day technical operations of the government.

The biggest winners of the Lushan meeting were the four organisation men: President Liu Shaoqi, Prime Minister Zhou Enlai, General-Secretary Deng Xiaoping, and Vice-Premier Chen Yun. By 1962, the drawn-out famine had so weakened Mao's standing that the four organisation men headed by President Liu halted the Great Leap Forward and reduced the collectivist nature of agriculture, e.g. allowing some private plots and rural markets. Needless to say, Mao felt betrayed, particularly by his handpicked successor Liu Shaoqi.

Revising the Four Principles

The great suffering caused by the Great Leap Forward affected many leading cadres profoundly and caused them to re-think the four fundamental premises of the 1958 economic programme. Liu Shaoqi, Zhou Enlai, Deng Xiaoping and Chen Yun — the four organisation men in the 1956 Standing Committee — formulated and implemented an economic recovery programme that compromised the common ownership (egalitarian) principle and the mass mobilisation ("politics in command") principle.

While the agricultural communes were kept in place, they were no longer the key economic units. Decision-making on production and income distribution was transferred from the commune (which averaged 4 600 peasant households) down to the production

brigade (which averaged 200–300 peasant households), and then gradually to the production team (which averaged 40 peasant households)²⁴. Small “private plots” were again legalised. More importantly, decentralisation in some areas went beyond the officially sanctioned production team level:

As the communes were decentralised, ... in at least a few areas, there was virtual reversion to private farming [where] farm households were permitted to make their own production decisions as long as they met their tax and other delivery obligations to the team and through the team to the communes” (Eckstein, 1977, pp. 73).

Many senior cadres also recognised that mass mobilisation as a method of intensifying work effort was more likely to lead to output disruptions than to output growth. The four organisation men in the Standing Committee modified the implementation of mass mobilisation from “political exhortations” to “material incentives”. While the party organisation within each (non–agricultural) enterprise remained the final authority on all internal enterprise matters, it was instructed to allow technically qualified personnel to make more decisions about production–related matters. This shift in attitude on “politics in command” can be clearly seen in the following statements by Deng Xiaoping in two separate speeches, the first delivered in October 1959 and the second in July 1962²⁵:

“Our basic method of work is ... to integrate the leadership with the masses, to pursue the mass line in all fields of work, to mobilise the masses boldly ... and rely on the strength of the masses to carry out the policies of the party ... It is obviously an erroneous view ... to consider mass movements necessary in revolution but maintain that matters are different in construction” (October, 1959).

“... In the past, we had too many movements. We had movements all the time and all those movements were national movements. This clearly didn’t work” (July, 1962).

In short, the disastrous consequences of agricultural collectivisation and crash industrialisation convinced many of the top party and government cadres that a more pragmatic attitude should be adopted in the economic sphere. It was in this pragmatic context that Deng Xiaoping uttered his famous “cats” lines in support of the *zerentian* (land responsibility) system where commune workers were paid according to the output of the land that they were assigned:

“All kinds of methods should be used in poor rural areas where farmers live a hard life. Some comrades in Anhui said, ‘No matter whether a cat is black or yellow, the cat is good as long as it can catch mice.’ This saying contains some truth. *Zerentian* is a new thing worth a try.” (Zhou, 1996, pp. 51)

The Second National Trauma: The Tumultuous Years of the Cultural Revolution

Mao’s retirement from active interference in state administration turned out to be short lived. In 1966, Mao launched an innocuous sounding campaign, the Cultural Revolution, to revitalise the Party to prevent it from slipping into the self–serving over–centralised bureaucratic culture of the Soviet Union. The students responded enthusiastically to Mao’s complaint about self–serving bureaucracies, and the provinces responded readily to Mao’s charge of over–centralisation. The provinces allowed the student activists, known as Red Guards, full rein to “bombard the headquarters” as directed by

Chairman Mao. The mobilisation of the masses and the denunciation of intellectuals were so complete that all schools (from kindergarten to university) were closed for the first few years of the Cultural Revolution.

The other members of the Standing Committee badly overestimated the extent to which their fates were tied to that of Mao, and underestimated the length that Mao was willing to go to destroy the party structure in order to regain control over it. They thought that this was just another political campaign that they would eventually control through co-option. This was not to be. Liu Shaoqi and Deng Xiaoping were rudely hauled from their residences inside Zhongnanhai (the part of the Forbidden City palace complex where the top party leadership lived), and publicly humiliated by the Red Guards. The palace guards stood by and watched the proceedings without intervening to rescue the president of China and the general-secretary of the party. Mao had conspired with the army to topple the party leadership! The party leadership had not taken sufficient notice of that. It was Lin Biao, the top military commander, who had issued the Little Red Book²⁶ as his paeon to Maoism.

Liu Shaoqi was thrown into prison in Henan province where he died in 1969 after being denied medical help, and Deng Xiaoping was exiled to work in a factory in Jiangxi province²⁷.

As is common in chaotic times, the revolution began to eat its own children. The Red Guards split into warring factions, often aligned with workers from different factories. Many cities with big munitions works became war zones with heavy artillery employed in the struggles over who was really fighting for the greater glory of Chairman Mao.

Mao had to turn to the army to restore order, which it did with bloody efficiency. Mao then solved the urban unemployment problem posed by the disbanded Red Guards by sending them to the countryside in 1968 “to learn from the masses”. The army was now the unchallenged foremost political force in the country after Mao. It was not surprising therefore that Mao anointed Lin Biao as his successor at the 9th Party Congress in April 1969. The 9th Party Congress re-inserted into the Constitution, what the 8th Party Congress had deleted; that Mao’s thoughts would guide all work of the party.

History repeated itself; the anointment was again a death warrant. Just as Mao was previously uncomfortable with the strong independent power base that Liu Shaoqi had in the Party, Mao began to feel threatened by the strong independent power base that Lin Biao had in the army. Lin Biao was aware of Mao’s growing unease, and he responded in 1971 with an assassination attempt that failed. Lin Biao died when the plane in which he was escaping ran out of fuel and crashed in Mongolia²⁸.

The death of Lin Biao and the discrediting of the army made the four ultra-leftists — Jiang Jing (Mao’s wife), Wang Hongwen, Zhang Chunqiao, and Yao Wenyuan (later immortalised as the Gang of Four) — the ruling coalition and the dominant political power after Mao. The Gang of Four true to its adherence to the common ownership and mass mobilisation principle pushed Mao’s anti-bureaucratic, egalitarian, and self-reliant policies to crippling extremes. More than 80 per cent of the top economic officials in 1965 were purged in the Cultural Revolution decade. Many central ministries maintained only skeletal staff, most of whom were sent to the countryside to reform themselves through labour.

Mao's anti-bureaucratic nature made his interpretation of the self-sufficiency principle as extreme as his interpretation of the mass mobilisation principle. Because Mao believed in regional self-sufficiency and in administrative guidance of resource allocation, he favoured a localised command economy. His unquestioned authority during the Cultural Revolution enabled him to slash the number of central level bodies in order to transfer economic planning to the provinces. In June 1970, the number of central ministries and state commissions under the State Council was reduced to 26 from 54, and the number of State Council agencies was cut to 32 from 78²⁹. Incentive schemes and private economic activities were forbidden, and ideological appeal to sacrifice for the greater good was the preferred method of raising productivity. Agriculture was "re-collectivised", mostly up to the production brigade (about 250 households) level — instead of up the commune (about 4 500 households) level as in 1958-62. The party secretaries in the factories replaced the managers and engineers in the running the factories, and political exhortations (class struggle sessions) completely replaced material incentive as the means to motivate work effort. Promotion was increasingly based on ideological conformity rather than on technical knowledge ("better red than expert"). International trade was seen as a nuisance to be tolerated primarily because of technological necessity, and the national distribution system was allowed (or, more likely, made) to atrophy in order to promote local self-sufficiency.

The consequences of "politics in command" of economic development were very disappointing however. Even Mao was not pleased. The annual real national income growth rate averaged only 5.8 per cent in the 1966-72 period compared to 15.3 per cent in the 1962-66 period. The poor economic performance was ultimately a national security matter because China's economy was getting less and less able to support a war against an invasion from a major power like its immediate neighbour, the Soviet Union. As Mao would not fault the ultra-leftist policies for the poor results, he faulted the poor management of these policies by the Gang of Four for the lacklustre economic outcome.

Furthermore, as with Liu Shaoqi and Lin Biao before, Mao was also not pleased with the absence of a counterweight to the rule by the Gang of Four. In 1973, he restored Deng Xiaoping as vice-premier in charge of the economy and as vice-chairman of the Party's Military Affairs Commission to re-build a loyal army. The remnants of the old guards rallied around Deng. It was therefore inevitable that conflicts with the Gang of Four were frequent and sharp. Deng being an experienced political operator gave as good as he received. The important observation is that the constant policy disputes within the government meant that Mao had to adjudicate and hence had the last word on almost all-important matters³⁰.

The fine political balancing act collapsed when Premier Zhou Enlai died in January 1976. Not willing to cede this key administrative post either to the technically-inept Gang of Four or to the ideologically-suspect old guards, Mao elevated the relatively unknown Minister of Public Security, Hua Guofeng, to the prime ministership. Lacking an independent power base, this new head of the government served entirely at the pleasure of Chairman Mao.

The new even finer political balancing act was upset in April 1976 when a memorial service for the late Zhou Enlai in Tiananmen Square erupted into a riot against the Gang of Four. The new Premier Hua Guofeng allied himself with the ultra leftists to blame Deng for the riot and to demand his ouster — an act for which Hua Guofeng would pay dearly afterwards. Mao, whose health was deteriorating rapidly, was greatly disappointed by the popular rejection of his utopian socialism. He believed the accusation that Deng had masterminded the riot, and purged Deng for the second time.

This time, however, the army realising that Mao did not have long to live, and still smarting from the post–Lin Biao purges launched by the Gang of Four, spirited Deng away to Canton to keep him out of harm's way. None of the Gang of Four had any military experience, and they had offended the military elite by promoting their less–than–qualified supporters in the army very rapidly. Mao died in September 1976, leaving Hua Guofeng defenceless against the Gang of Four. Less than a month later, the army under Ye Jianying (with the grateful agreement of Hua Guofeng) arrested the Gang of Four. The Cultural Revolution was finally over after ten years.

It will be shown that the arrest of the Gang of Four unleashed a process of de–Maoification by the cadres purged in the Cultural Revolution. The rehabilitated cadres forged a temporary united front among themselves in order to wrest political power from the remnant Maoists. Part of their challenge to the Maoists was an alternative economic strategy that permitted family farming, some use of material incentive, and a limited degree of integration into the world economy. This programme of economic deregulation and economic opening, in turn, unleashed the engines of prosperity innate in all economic systems.

III. THE POLITICS OF ECONOMIC REFORM

Removing the Shadow of Mao

The arrest of the Gang of Four was a *coup d'état*. It made Marshal Ye Jianying the most important leader in China. In October 1976, Ye Jianying could have made himself the *de facto* supreme leader and retained Hua Guofeng as a puppet ruler. Instead, Ye Jianying chose to be the kingmaker by supporting collective leadership. On the one hand, he supported the elevation of Hua Guofeng to party chairmanship, and, on the other, he campaigned for the restoration of Deng Xiaoping to the four posts (vice-chairman of the party, vice-premier of the government, vice-chairman of the CPC Military Affairs Commission, and chief of staff of the People's Liberation Army) that Deng held when he was dismissed in April 1976.

Deng Xiaoping was restored to his four posts in July 1977, and the 11th Party Congress held in August 1977 elected a Standing Committee that consisted of (in order of party rank) Hua Guofeng, Ye Jianying, Deng Xiaoping, Li Xiannian and Wang Dongxing. Li Xiannian was the Minister of Finance from 1957 to 1975. Wang Dongxing commanded the military units that guarded the top leadership. He had also executed the operation to arrest the Gang of Four.

Hua Guofeng, Ye Jianying, Li Xiannian and Wang Dongxing weathered the Cultural Revolution unscathed because Mao had judged them to be intensely loyal to him personally, and adequately left in ideology. However, unlike Hua Guofeng and Wang Dongxing, Ye Jianying and Li Xiannian were members of the political leadership before the Cultural Revolution, and they had long working relationships with the "capitalist roaders" purged by Mao and the Gang of Four. Ye Jianying and Li Xiannian were therefore comfortable with the rehabilitation of the purged cadres. The flood of rehabilitated cadres strengthened Deng Xiaoping's position immensely and reduced his political dependency on Ye. Hu Yaobang, the head of the Communist Youth League and a protégé of Deng, led a successful campaign to change the party's official verdict of the 1976 Tiananmen riot from "reactionary" to "revolutionary" in November 1977, a change that cleared Deng's party record completely³¹.

The process of undermining Hua Guofeng's rule had begun. The old guards strengthened their position at the Third Plenum of the 11th Party Congress in December 1978 with the appointment of Hu Yaobang as the chief secretary of the party³², and Chen Yun (a member of the 1956 Standing Committee) to the Standing Committee. Rehabilitated cadres replaced many of Hua's loyalists in other party positions. Deng Xiaoping also pushed through economic policies that permitted some decentralisation of economic management, and a limited amount of integration into the world economy.

The decentralisation measures were the introduction of less restrictive production contracts in agriculture, and some degree of profit sharing in industry. Under the Cultural Revolution, the economic unit for agricultural production was usually the production brigade, which signed output contracts with the commune. The Third Plenum moved the contract system down to the production team; i.e. the production responsibility was contracted to

small groups (*da bao gan*, or *baochan dao zu*), the arrangement used in the 1962-66 period. Contracting to individual households (*baochan daohu*) by the production team was explicitly forbidden.

In the rural areas, the culmination of Mao's death, the arrest of the Gang of Four, and the introduction of lower-level agricultural contracts emboldened the peasantry in some provinces to go beyond the approved *baochan dao zu* system to the forbidden *baochan daohu* system (the household responsibility system)³³. The rehabilitated cadres in these provinces turned a blind eye to the re-emergence of household farming because of their desire to quickly build a popular base to challenge the Hua Guofeng loyalists. Peasants in other provinces, seeing the great increase in agricultural output after the reversion to family farming, and the implicit acceptance by the authorities of this ideological innovation, joined in the spontaneous de-collectivisation of the communes. At the end of 1980, 40 per cent of production teams in Anhui, 50 per cent in Guizhou, and 60 per cent in Gansu were implementing the illegal household responsibility system³⁴. The outcome is well known, the reversion to the centuries-old practice of family farming brought unprecedented prosperity to the country, and legal recognition was accorded to the household responsibility system in January 1983.

Deng started the re-integration of China into the world economy in April 1979 by establishing four Special Economic Zones (SEZs) in south China where foreign direct investment was welcomed. The goal of the SEZs was to enable the production of labour-intensive manufactured goods for export under free trade conditions. In addition to income tax holidays and exemption from central planning regulations, foreign and domestic firms within the SEZs could import their capital equipment and raw materials duty-free, export the processed goods expeditiously, and hire and fire workers freely. The SEZs were, in short, export platforms for multinational corporations. The inspiration behind them was the export processing zones in East and Southeast Asia that had launched their dynamic, export-led industrialisation without opening significantly their domestic markets to import competition.

Deng Xiaoping's economic initiatives, which emphasised the use of material incentives to increase economic efficiency and the use of international trade to promote industrialisation, contrasted sharply with Hua Guofeng's economic programme that was launched earlier with great fanfare in February 1978. The Hua programme sought to accelerate economic growth through massive capital accumulation and large-scale importation of modern technology — the same economic remedies that were implemented in the early 1970s by Edward Gierek in Poland and by Nicolae Ceasescu in Romania. The crash programme to develop heavy industries and infrastructure involved “120 large-scale projects, including iron and steel complexes, coal mines, oil and natural gas fields, power complexes, railroad lines, and harbors” (Baum, 1994, pp. 54). The great amount of construction caused the budget deficit, trade deficit, money supply and inflation to rise in turn.

Hua's economic programme very quickly came under fierce criticism from the rehabilitated cadres as ill conceived, overly expensive, and badly managed. Deng's supporters derided Hua's economic programme as being based on the “whatever” principle — the uncritical implementation of whatever decisions that Chairman Mao had made regardless of the context in which the decisions were made, and regardless of the contradiction between decisions made at different times. Deng's economic programme,

on the other hand, was described as based on the “seek truth from facts” principle. By labelling his market-oriented measures “reforms”, Deng was emphasising that Hua’s programme was amplified *status quo* economics, an amplification of the two traditional biases of central planning — the favouring of industry over agriculture, and the favouring of heavy industry over light industry.

As Deng’s political stature increased with the overwhelming success of his agricultural reforms, Chen Yun was appointed in April 1979 to “readjust, reform, correct and improve” (*tiaozheng, gai, zhengdun, tigao*) Hua’s massive industrialisation programme. In February 1980, Wang Dongxing, a major Hua supporter, was removed from the Standing Committee, and Hu Yaobang and Zhao Ziyang, two Deng protégés, were elected to the Standing Committee.

By April 1980, Zhao Ziyang was running the day-to-day operations of the government, leaving Hua Guofeng as the Prime Minister in name only. Four months later, Hua was stripped of the prime ministership. This humiliating practice of effective replacement before formal changes occurred again in December 1980 when the party announced that Hua would step down as chairman of the central committee in the following year, and that Hu Yaobang would assume the duties of the chairmanship immediately.

At the 8th Plenum of the 11th Party Congress held in June 1981, Hua was formally removed as chairman of the party and as chairman of the Military Affairs Commission of the party. (Deng Xiaoping was elevated from vice-chairman to chairman of the Military Affairs Commission.) While Hua was allowed to keep his seat on the Standing Committee³⁵, he was demoted to the lowest ranking member in the Standing Committee. The personal animosity that many rehabilitated cadres had towards Mao’s chosen successor is well revealed in the party resolution released with the formal announcement of Hua’s retirement from these two posts:

“Comrade Hua Guofeng eagerly produced and accepted a new cult of personality ... In 1977 and 1978, Comrade Hua Guofeng promoted some ‘Leftist’ slogans in the realm of work?resulting in severe losses and calamities in the economy ... [Although he] has also done some successful work, it is extremely clear that he lacks the political and organizational ability to be chairman of the party. That he should never have been appointed chairman of the Military Affairs Commission, everyone knows.” (quoted in Baum, 1994, p. 117)

The 8th Plenum of the 11th Party Congress also accepted an assessment of Mao’s record (“Resolutions on Certain Questions in the History of Our Party Since the Founding of the People’s Republic of China”) which concluded that most of Mao’s positive contributions were made before 1957, and that most of his mistakes were committed from 1957 onward. Specifically, Mao was “chiefly responsible for the grave ‘Left’ error of the cultural revolution”³⁶. Deng Xiaoping was to pronounce later that 70 per cent of Mao’s actions were positive, and 30 per cent were negative — the same ratio that Mao had arrived at about Stalin’s record after Khrushchev’s denunciation of Stalin in 1956. The political castration of Hua Guofeng and the recognition of Mao’s grievous mistakes in June 1981 marked the formal burial of Maoism as a political and economic programme.

Hua Guofeng was dropped from the new Standing Committee elected at the 12th Party Congress held in September 1982. The post of party chairman was abolished and the post of general secretary was revived, and Hu Yaobang was elected to the new post.

The Three Competing Economic Programmes: The Good, the Bad, and the Ugly

With the benefit of hindsight, the membership of the Standing Committee after the 6th Plenum of the 11th Party Congress in June 1981 represented three broad economic programmes that could be classified as the Maoist programme, the modified Soviet programme, and the market-oriented programme. The Maoist programme was leftist in orientation. The Soviet programme was conservative in that it sought to restore the economic system of the 1962-66 period. The market-oriented programme was inspired, in part, by the market socialism of Oskar Lange (1936), and, therefore, liberal in aspiration³⁷.

In 1981, the Maoist programme was being pushed into extinction by the coalition of central planners and market-oriented reformers, which would split later and vie for the centre stage of policymaking. It is important to keep in mind, and something that will be clarified later in this section and in Section IV, that the terms describing the competing political factions would change over time, partly because the contents of the competing economic programmes changed over the course of the reform. Two prominent examples would be, one, the absorption of the remnants of the leftist faction into the conservative faction to oppose the liberal faction; and, two, the evolution of the liberal reform programme from Langan market socialism to “socialist markets with Chinese characteristics”.

In June 1981, Hua Guofeng, Ye Jianying, and Li Xiannian the beneficiaries of the Cultural Revolution, represented the Maoist programme which believed in complete state ownership of the economy, with agriculture collectivised up to at least the production brigade level (200 to 300 households), and with regional self-sufficiency in industrial goods. These Maoists differed from the Gang of Four in that the former regarded the degree of mass mobilisation and the degree of economic decentralisation to provincial leaders during the Cultural Revolution as having been excessive.

The modified Soviet programme was represented by Chen Yun. The Soviet model was modified to permit decentralised farming (even down to household level contracting if necessary) instead of insisting on agricultural communes and state farms to be the dominant organisational mode in agricultural production. This bow to the superiority of the quasi-capitalist (since land was still state-owned) mode was seen as realistic accommodation to the low class consciousness of the peasantry (fostered by extreme poverty and by lack of education), and the economic dominance of the agricultural sector. The defining features of the modified Soviet programme were the retention of central planning as the primary mechanism for resource allocation (particularly outside of agriculture), and the use of material incentives as a supplementary device to increase the efficiency of attaining the targets set by the plan. To use Chen Yun’s analogy, the endpoint of reform was a “bird cage” economy where the bird represented the economy, the cage represented the central plan, and the size of the cage represented the market. The reasoning and conclusion of Chen Yun was:

“One cannot hold a bird tightly in one’s hand without killing it. It must be allowed to fly, but only within its cage. Without its cage, it would fly away and become lost. Of course, the cage must be of appropriate dimensions ... That is to say, one may readjust the size of the cage ... [but] regulation of economic activity by the market must not entail abandonment of the orientation provided by the plan.” (quoted in Baum, 1994, p. 152)

It must be made clear that although Chen Yun was open to the decentralisation of agricultural production to the household level unlike some of the other proponents of Soviet-type central planning, his support was contingent on land remaining state-owned, on agricultural production remaining centrally directed, and on agriculture remaining subservient to industry³⁸. In essence, Chen Yun's modified Soviet model reflected the traditional Marxist position that an unfettered market mechanism was inherently inefficient in allocating resources, ineffective in ensuring the full employment of resources, and biased toward accentuating income inequality³⁹.

The market-oriented programme in 1981 was represented by Deng Xiaoping, Hu Yaobang and Zhao Ziyang. The distinguishing characteristic of this programme is its openness to learning from the experiences of economic growth in other countries, particularly from Hungary and Yugoslavia in the beginning, and then increasingly from Korea, Singapore, and Taiwan. The contrasting economic performance of North and South Korea, and of East and West Germany, convinced Deng Xiaoping and his two protégés that market economies generate higher growth than planned economies. The rapid climb into economic prosperity by China's capitalist neighbours in East Asia also convinced them that integration into the global trade and financial systems was another important key to sustained economic progress.

While Deng Xiaoping, Hu Yaobang and Zhao Ziyang remained committed to state ownership, it is clear that they viewed its attainment as a long-term goal. To Hu Yaobang and Zhao Ziyang especially, private ownership, even if significant in some sectors, was acceptable in the medium run because they interpreted the economic disasters of the Maoist period to have been caused more by feudalism than by bourgeois liberalism. Mao's idiosyncratic one-man rule and selection of his own successor typified to them the rule of a feudalistic emperor⁴⁰.

The theoretical presumption of Deng, Hu and Zhao was that the period between the collapse of the feudalistic Qing dynasty in 1911 and the establishment of the communist state in 1949 was too short and too chaotic to allow capitalism to develop fully and play its historical role of industrialising China. The outcome was that China was still overwhelmingly agricultural when the CCP created the socialist state. Deng Xiaoping, Hu Yaobang and Zhao Ziyang therefore considered the use of capitalist tools to industrialise faster as historically and theoretically justified. Even if capitalist tools required the existence of capitalists to work well, there was nothing for the party to fear. This was because the party was in firm political control of the country, and so "capitalism" was a policy variable, a "disease" that could be terminated whenever desired. This confidence led Deng Xiaoping to pronounce in October 1984 that "a little capitalism isn't necessarily harmful"⁴¹.

Beyond the confident assumption that capitalism could be contained at will, Deng Xiaoping, Hu Yaobang and Zhao Ziyang also held the more sophisticated view that capitalist tools and capitalism were separate, independent entities, and that many capitalist tools could be compatible with socialism. This pragmatic attitude toward capitalist tools was derived from Deng, Hu and Zhao's belief that Marxism was a dynamic doctrine. Their position is aptly summed up in the now famous phrase "Practice is the sole criterion for testing truth (*Shijian shi jianying zhenli de weiyi biao zhun*)"⁴². Deng Xiaoping once told a visiting African head of state: "I can't tell you what socialism is exactly; don't practice so-called socialism in your country"⁴³. Hu Yaobang highlighted the irrelevance of dogmatic Marxism to contemporary problems by pointing out that Marx had never been in a car. Zhao Ziyang put it even more bluntly: "What is socialism? No one can clearly define it"⁴⁴.

The very important, far-reaching implication from the view that Marxism is a living science, and that the party must “seek truth from facts” was that Deng, Hu and Zhao were not particularly concerned about whether economic decentralisation and economic opening would change the character of Marxism in the long run. Hence, the appearance and quick growth of non-state industrial enterprises in the rural areas, outside of the central plan in the early 1980s, did not raise ideological alarm bells to Deng, Hu and Zhao. However, their willingness to approve many new phenomena as compatible with socialism frequently undermined the economic interests and political authority of other senior party leaders, and thus united these other leaders in accusing the new market-oriented policies to be revisionist in nature.

The key characteristics of the Maoist, Stalinist and Langlean economic programmes of the 1977-85 period are summarised in Table III.1.

Table III.1. Key Features of the Three Competing Economic Programmes in the 1977–85 Period

	The Maoist Economic Program	The Stalinist–Style Economic Program	The Market–Oriented Economic Program
Ideal organisation of a socialist economy	Economy is decentralised through planning at regional level to promote regional self-sufficiency. <i>Regional command economies.</i>	Central planning with limited market activities. <i>Birdcage economy.</i>	Market socialism. <i>Complete decentralisation.</i>
Country of inspiration	Utopia?	Soviet Union	Hungry and Yugoslavia, and then Korea and Singapore
Chief instrument to motivate work effort	Political exhortations <i>Mind over matter.</i>	Limited use of material incentives <i>Mostly mind matters.</i>	Material incentives <i>Matter over mind.</i>
Agricultural sector policy	Large communes <i>Maximise egalitarianism.</i>	Small co-operatives <i>Medium is efficient compromise with ideology</i>	Household farming <i>Small is beautiful.</i>
Urban Industrial sector policy	Complete state ownership with central plan dictating all enterprise operations. <i>Stalin is right.</i>	Complete state ownership with central plan dictating all enterprise operations. <i>Stalin is right.</i>	Complete state ownership with complete operational autonomy to managers. <i>Stalin is wrong.</i>
Rural industrial sector policy	Central planning at commune level to increase self-sufficiency	Reserve industries for urban areas.	Rural enterprises are acceptable if collectively owned and self-financing
Service sector policy	Complete state ownership with central planning.	Small private businesses are acceptable, and central plan for SOEs.	Small private sector is acceptable, and operational autonomy for SOEs.

Table III.1 shows that the Maoist, Stalinist and Langean economic programmes embraced with different degrees of enthusiasm the four principles of that guided the Great Leap Forward (common ownership to ensure egalitarianism, mass mobilisation to induce work effort, central planning to favour heavy industries, and self-sufficiency to avoid dependence on capitalist and revisionist countries). The Stalinists and Langeans were willing to tolerate deviations from common ownership if they were small in scale (for example, private retail stalls), but the Maoists condemned these minor deviations as “capitalist weeds” that should be resolutely stamped out. The mass mobilisation principle was embraced most fervently by the Maoists, half-heartedly by the Stalinists, and perfunctorily by the Langeans. While the Maoist and Stalinists used central planning as the principal tool of economic co-ordination, the Langeans rejected it completely. The principle that was embraced equally ardently by all three competing programmes was the self-sufficiency principle⁴⁵.

The Supporters of the Three Factions

Needless to say, the strongest supporters of the Maoist programme were the cadres who were promoted during the Cultural Revolution. Support for the Maoist programme were particularly top heavy because the Gang of Four had in many cases picked radical hotheads in the lower levels of the hierarchy (or sometimes out of the factories) and put them in charge of the organisations. As the Maoist period was one of shrinking the role of the state, there was no large-scale intake of Maoists into party and government organisations, and so the result is that the Maoist heads of organisations lacked grass-root support in their organisations.

The army was the exception. Mao did not humiliate and decapitate the top echelon of the army (except for Lin Biao and his closest associates who tried to assassinate Mao), and did not reduce the size of the army. The army in fact expanded its influence into the party and administrative spheres after the removal of the civilian leadership there, and the outbreak of factional struggles within the Red Guards. The rise of the army within the Maoist state was well-captured by the increase in the number of army representatives elected to the Standing Committee from one (Lin Biao) in the 1969 9th Party Congress to three (Zhu De, Ye Jianying, and Li Desheng) in the 1973 10th Party Congress⁴⁶. The army was certainly a formidable Maoist stronghold in the early 1980s.

Most of the party and government cadres supported the restoration of Stalinist central planning in the industrial and service sectors, and the introduction of team or household production contracts. This belief in the efficacy of modified central planning was based on, one, the satisfactory fulfilment of the 1st Five-Year Plan (1953-57), and, two, the successful recovery of the economy under these policies in 1962-65 from the Great Leap Forward. The fact that the cadres' bureaucratic power was amplified by the central plan certainly increased their support for the plan. The result is that institutionalised civilian power favoured the “bird cage economy” blueprint.

The intellectuals were the strongest supporters of the market-oriented programmes because they were the most knowledgeable about the great successes of their capitalist neighbours. The intellectuals particularly liked the decentralisation of decision-making in the market-oriented programme, because it implied decentralisation of political authority to some extent. They felt that the centralised authority during the central planning periods and the Cultural Revolution made their persecution harsher. Provincial and local cadres were also supporters of the market-oriented programme because of its emphasis on the decentralisation of decision-making powers. Although the Maoist programme also offered economic decentralisation, the chaos of the Maoist period turned these regional cadres against the Maoist programme. The market-oriented programme had a natural constituency in the enterprise managers because it would increase their operational autonomy. In short, non-institutionalised civilian power supported the market socialism programme.

Since the party and state bureaucracies opposed the market socialism programme, Hu Yaobang and Zhao Ziyang had to rely on (or create) *ad hoc* policy think tanks outside of the state-party apparatus to help them to design market-oriented reform policies. For example, the Rural Development Research Group founded in 1980 provided the empirical justification for the household responsibility system; and the Economic Reform Institute (*Tigaisuo*) founded in 1985 constantly proposed enterprise reforms that tested the limits of political tolerance for capitalist methods. The researchers at these *ad hoc* think tanks were usually in their late twenties and early thirties, and had limited bureaucratic experiences. The facts that these think tanks were outside of the power structure, and that their personnel had shallow roots in the bureaucracies had important negative consequences. These liberal think tanks lacked institutional clout to push their policies and to demand resources to conduct many large-scale studies. Furthermore, their survival was linked to the political careers of Hu Yaobang and Zhao Ziyang. Both the Rural Development Research Group and the Economic Reform Institute were disbanded in 1989 after the sacking of Zhao Ziyang.

In terms of absolute members, the support for market socialism was the greatest. However since China was not a Western-style democracy, the party and state cadres, and the army each had about the same amount of influence on policy making as the supporters of market socialism. This situation necessitated that compromises among these three groups must be reached before large changes in economic policies could occur. The constant political bargaining and occasional shifts in political alignments among the supporters of the Maoist, Stalinist and Langan economic programmes gave China's economic reforms their incremental nature, and the appearance of "two steps forward and one step backward".

Deng Xiaoping Acting as the Fulcrum of the Factional Disputes

Placing Deng Xiaoping in the liberal reform camp is difficult. The fact that Deng actively promoted the careers of Hu Yaobang and Zhao Ziyang put him in their camp, but the fact that he also actively accommodated the concerns of the conservatives would put him close, if not sometimes in, the middle of the central plan-market spectrum throughout the 1978-90 period. In some disputes, he kept himself above much of the fray and sometimes reversed the liberal economic policies inspired by him. Before 1991, whenever the political spectrum shifted, Deng would usually also shift in order to be on the new middle ground.

It was only after Deng's sojourn to south China (*nanxun*) in February 1992, when he pronounced that China had rather to guard against leftist economics than rightist economics, that one could unambiguously state that Deng had engaged himself in direct confrontation with the Stalinists.

There were good reasons for which Deng actively pursued the ideological middle in the 1978-90 period even though he was the most powerful political figure on the political stage. The first reason was that Deng needed the united support of the conservative members of the rehabilitated faction in order to be able to sack Hua Guofeng. Since Hua was personally chosen by Mao to be his successor, he inherited the loyalty of the less educated lower and middle echelons of the party. More important, the continued chairmanship of Hua provided a potential ideological rallying point for future disaffected members of Deng's coalition. Only with the replacement of Hua by a Deng protégé was Deng's grip on the party assured.

The second reason for Deng's choice of ideological moderation was that the main factions in the army, especially in the early years, saw themselves as the defenders of Mao's legacy which emphasised nationalistic self-reliance in economic matters, and state control of industries. The army, after all, had a tremendously privileged position under Mao. The army was not just a fighting force; it was also in charge of many strategic heavy industrial enterprises. It was therefore rightly wary of possible changes in its functions with the dismantling of the centrally planned economy, and wary of the more liberal political atmosphere that allowed the wide publication of fictional works which revealed widespread corruption in the army⁴⁷.

Deng's attention to the army was well justified, as seen in Hua's last-ditch appeal to the army in Spring 1981 to support his bid to remain chairman of the party. The response of the army validated Deng's reading of the army's leftist tendencies. The army strongman Ye Jianying opposed the appointment of Hu Yaobang and declared that he would "advance or retreat side by side with Chairman Hua Guofeng". The intervention of the army resulted in Hua being retained as a vice-chairman of the Party, and as a member of the Standing Committee, albeit the lowest ranking member.

The third reason for Deng's eclectic ideology was the same reason for which Mao actively created counterweights to the current ruling group. The existence of competing groups required an arbiter, and this role gave Deng (just as it did earlier to Mao) good personal control over policy decisions.

Deng was most skilful in his official pronouncements to support both sides of many issues. In August 1980 when the internal party debate between the conservatives and liberals on whether bourgeois liberalism or feudalism was the bigger barrier to socialist modernisation was at its height, Deng froze further escalation of the debate by criticising both bourgeois liberalism (for promoting decadent lifestyle) and feudalism (for allowing over-concentration of power in the hands of a few leaders). When the debate resurfaced at the 12th Party Congress in 1982, Deng supported the market reformers' proposal for opening China more, and at the same time sided with the conservatives by warning the party to guard against decadent ideas from abroad. Without missing a beat, Deng juxtaposed key phrases from both camps to conclude that only with the establishment of socialist spiritual civilisation could the socialist modernisation that was being pursued with the economic tool (material incentive) be successful.

The fact was that Deng wanted to keep the reform coalition together even after the downfall of Hua Guofeng because he personally felt that internal party conflicts could lead to civil war, with ambitious provincial governors consorting with ambitious army commanders to support particular factions within the central leadership. Deng's assessment about a possible civil war was not unique; it was shared by Mao Zedong near the time of his death⁴⁸.

The fourth reason for Deng's seemingly neutral stance was that it allowed him to be sufficiently distant from the policies proposed (albeit at Deng's instigation many times) and implemented by the liberal reformers. The primary responsibility for an unexpectedly large negative outcome from any reform would hence fall on Deng's agents rather than on himself.

The Subtleties of Factional Alignments

From the moment that the Gang of Four was arrested in October 1976, the leftists under Chen Yun entered into a concerted campaign with the liberal reformers under Deng Xiaoping to dethrone Hua Guofeng. The key to success lay in securing the agreement of the army to such a change. The opportunity to do so came after February 1979 when the army was ordered to conduct a *blitzkrieg* on Viet Nam to cripple Viet Nam's war effort in Cambodia⁴⁹. The People's Liberation Army's (PLA's) incursion into Vietnam was a great disappointment to the political leadership and a great embarrassment to the military leadership. Using only its militia forces, the Vietnamese were able to fight the PLA to a draw, and inflicted more than thirty thousand casualties on the PLA. Under the cover of restoring the PLA to an effective fighting force, the rehabilitated cadres (most of whom were military commanders before 1949) purged many of the military commanders and political commissars appointed during the Cultural Revolution.

With improved control over the army, the rehabilitated cadres dropped Hua Guofeng from the Standing Committee elected at the 12th Party Congress held in September 1982. Earlier in June 1981, the remaining Maoists, Ye Jianying and Li Xiannian, had joined Chen Yun to lead the conservative wing of the Party because they "were unwilling to grant Deng and his successors an open mandate to depart further from China's Marxist-Leninist heritage" (Hamrin, 1984, pp. 488).

Hence, policy-making from 1983 onwards was largely the product of competition between the conservative central planners and the liberal market reformers. This characterisation of the policy struggles in the 1983-88 period has to be qualified in two ways. First, membership in either camp was not always caused by differences in ideological preferences or differences in technical analyses. Personal feelings and career considerations were also important determinants. For example, Deng Liqun (no relative of Deng Xiaoping) was a supporter of liberal economic policies until the chairmanship of the party was given to Hu Yaobang instead of him. Deng Liqun crossed over to the conservative wing, and campaigned actively against the reform policies, first, of Hu Yaobang, then, of Zhao Ziyang, and, now, of Jiang Zemin.

The second qualification to the idea of a liberal-conservative struggle is that there were active struggles within each faction. The struggles within the liberal wing were not much less intense than the conservative-liberal struggles because the liberals were in power and hence had more resources to allocate, while the conservatives were mostly united in unseating the liberals. In the struggle to succeed Deng Xiaoping, the two leaders

of the liberal faction, General Secretary Hu Yaobang and Premier Zhao Ziyang, locked horns over so many policy issues that Premier Zhao wrote a secret letter to the Politburo in 1984 saying that he could no longer work with General Secretary Hu.

The 1984 State Sector Reform and its Radicalising Effects

In 1984, the party extended its decentralisation programme of reform to the state sector. A dual-price system was established for many items. An SOE had to deliver to the state a contracted amount of output at the plan price, and the SOE could sell its excess output in the free parallel market for that good. The SOE would receive a certain amount of inputs from the state at the plan price, and it was free to buy more in the free parallel market for that input.

Beside partial price liberalisation, there was also transfer of decision making about many operations of the SOE to its manager from the local planning bureau e.g. decisions on production technique, output mix, marketing, investment and bonus payments. The SOE reform package was inspired in large part by the market socialism of Hungary and Yugoslavia.

The partial liberalisation and partial decentralisation character of the 1984 enterprise was to the liking of both the conservative and the liberal reformers because of the political implications that both camps had drawn from the Polish labour strikes in 1980 and 1981. The conservative reformers realised that the rigidity of traditional Soviet central planning was detrimental to growth, and that their political legitimacy ultimately rested on strong growth. The liberal reformers realised that deregulation, especially abrupt deregulation, would undermine their support within the party and state bureaucracies, which owed their power to control over material allocation. So, to the conservatives, the partial reform was a good compromise that would generate the growth that would appease the populace from engaging in Solidarity-type activities. To the liberals, partial reform was a good compromise that would ensure a united front within the coalition to prevent the emergence of any Solidarity-type organisation.

The results of the reform were an unpleasant surprise. SOE profits dropped upon the implementation of the reforms, and worsened steadily over time. The result was that total state revenue went from 34 per cent of GNP in 1978 to 25 per cent in 1984 and then to 20 per cent in 1988⁵⁰. Because of the great emphasis on keeping the budget deficit low, the collapse in the profitability of the SOE sector under partial decentralisation reform caused state expenditure (as a percentage of GDP) to fall equally dramatically (see Table I.2).

The downward trend in SOE profitability was clear to members of Zhao Ziyang's think tank, the Economic Reform Institute (*Tigaisuo*), very soon after the start of the 1984 reform. After analysing a 1985 nation-wide survey of SOEs, the Economic Reform Institute concluded that decentralisation reforms have enabled SOE managers to engage in excessive consumption and reckless investments, both of which reduce profitability. The SOE managers were overcompensating themselves and the workers through undeservedly large bonuses, and through indirect means like housing and recreation. The managers also over-invested because they expected to be bailed out by the state if their investments failed. The Chinese had independently discovered the "soft budget constraint" phenomenon that Janos Kornai (1980) had noted in Hungary.

The disappointments with the Lange–inspired programme of SOE reform radicalised many of the advisors to the liberal reformers. Bold, and somewhat deliberately vague, proposals for “ownership reform” became increasingly common over the 1986-89 period. Li Yining, professor of economics at Beijing University, electrified the discussion of Chinese intellectuals when he proclaimed that “Economic reform can fail because of the price reform, but its success cannot be determined by price reform but by ownership reform”⁵¹. Li Yining, and a flurry of more radical articles advocated that SOEs be transformed into shareholding corporations.

Articles by Li Yining (1986*a, b, c*) appalled the conservative planners. Since the national political leadership is determined within the narrow confines of the party, the conservatives sought to rein in the market reformers by using the traditional Stalinist–Maoist ploy of portraying the other side as deviating from the party line. The market reformers were alleged to be guilty of bourgeois liberalism, and indifferent to socialism in China being subverted by peaceful evolution toward capitalism. The attack on the market reformers failed, and the reason was that the basis for political leadership was no longer political adherence but economic achievements. Most of the party leadership, jaded by the political struggles of the Mao period, had implicitly come to the view that the main basis for political legitimacy was good economic results. Since Hu Yaobang and Zhao Ziyang were producing high growth rates that were unprecedentedly sustained, most party stalwarts not directly engaged in the power struggle were willing to suspend judgement on whether the new economic methods were compatible with socialism.

The Political Consequences of Inflation

So it was to be expected, but ironic nevertheless, that what finally brought Hu Yaobang and Zhao Ziyang down was economic in origin. Hu and Zhao’s mistake was to have focused too much on output growth and not enough on price stability. The soft budget constraint emboldened enterprise managers to abandon prudence and allow the amount of investment to be determined by the maximum amount of loans they could get from the banks. The post-1979 revenue–sharing arrangement motivated local leaders to pressure local banks to exceed their credit quotas in order to meet local loan demands. The local banks complied with the loan requests because, one, they, too, operated under soft budget constraints, and, two, until 1993, they were under the joint leadership of the local leaders and their head offices in Beijing. Furthermore, because over–quota lending was a nation–wide phenomenon, making punishment unlikely, and, because the national credit plan was always revised upwards during the year to accommodate the unauthorised credit growth, the local banks were comfortable about ignoring their assigned loan quotas. The fact that Premier Zhao Ziyang loosened monetary policy several times in the 1984-87 (each time within a few months after tightening monetary policy to fight inflation) only reinforced the desire of the local banks to cater to local loan demands.

In retrospect, it appears that Zhao Ziyang also received bad advice on the relationship between money growth and inflation. Much of the econometric projections of inflation were unrealistically optimistic because they were based on estimation periods that included the pre-1984 years when price controls were in full force. At the same time, there were many facile arguments that China’s dramatic structural transformation has rendered its inflation process entirely different from the rigid inflation processes of developed economies.

Given the reckless investment by SOEs and their overcompensation of managers and workers, SOE profit rates naturally decline. Many policymakers, not understanding the new “soft-budget constraint” phenomenon, interpreted the profit rate decline to reflect technological obsolescence, and recommended more loans to SOEs to enable technical renovation to restore their competitiveness. So, wrong diagnosis, wrong advice, and price decontrol in a situation of inherited monetary overhang, coupled with Hu Yaobang’s and Zhao Ziyang’s emphasis on keeping the growth rate high, caused inflation rates in the 1985-88 period to be very much higher than in the preceding 20 years (see Table I.2).

Inflation was a new phenomenon to Hu Yaobang and Zhao Ziyang, and they underestimated its wide-ranging negative impact on the body politic. The populace, familiar for more than 20 years with hardly changing price levels, reacted with great alarm and anger at the (what is really) moderate inflation. The anger arose because the inflation was widely seen to be the result of price gouging by privileged party members.

This erroneous perception about the origin of inflation came from the two ways in which inflation manifested itself. First, the existence of monetary overhang in 1984 and the faster growth of credit after that naturally caused prices in the free retail markets to rise, and pull up the prices in the (free) parallel market for intermediate inputs.

Second, a dual-price system naturally creates corruption. People with political connections, for example, children of the high cadres, would appropriate the goods sold at the plan prices and resell them at the higher prices of the free parallel markets. However, in the eyes of a populace unused to inflation, it appears that monopsonistic practices raised the prices of intermediate inputs, which in turn raised retail prices. Inflation caused by corruption, if widely believed to be true, is an explosive political issue in any country, and China was no exception.

In the last quarter of 1985, students in several universities held demonstrations against a motley collection of personal complaints and society-wide issues: poor living conditions, low stipends, rising inflation rate, corruption, and penetration of Japanese goods into Chinese markets. The student demonstrations got bigger at the end of 1986, “several tens of thousands of people, students and non-students alike, from more than 150 colleges and universities in 17 cities, participated in demonstrations in the last half of December 1986”⁵². As in 1985, “the complaints of the student demonstrators varied widely and lacked coherent focus. Some clamoured for electoral democracy; others complained about the low quality of campus food and living conditions (including the presence of rats in student dormitories); still others protested against inflation, corruption, rising tuition fees, and the elimination of automatic student aid”⁵³.

If one were to put the 1985 and 1986 student demonstrations in the context of Chinese political culture as described by the famous Sinologist Lucian Pye, one would interpret the demonstrations to be demands for improvements in student benefits cloaked and dignified as components of a broader social justice programme. In short, the students were striking for selfish interests but the style of political confrontation was to seize the moral high ground⁵⁴. The students wanted lower tuition fees, higher pay, and better housing, and they used inflation and corruption to mobilise support for their causes.

However, without disputing the possible selfish interests of the students, one can also see other motivations at work. Since 1980, the government has permitted active academic interaction with foreign countries because it recognised that this was an efficient, low cost method of acquiring foreign technology. An important by-product of this open

policy was the enlargement of the information sets of Chinese intellectuals and literate urban dwellers to include analytical understanding of the socio-economic and political systems of the advanced capitalist countries, and the political trend of democracy in South Korea and Taiwan after long periods of authoritarian rule. Since most intellectuals had more interests vested in the future of China than in the existing economic and political institutions, they were naturally pro-reform. Many of them (e.g. the physicist Fang Lizhi) came to believe that political competition would not produce political chaos but would render the political system more responsive to their socio-political aspirations, just as economic competition does not normally produce economic chaos but instead makes the producers more responsive to the material demands of the consumers. Hence, many intellectuals saw corruption as the consequence of the lack of political transparency, and therefore linked their protests against corruption with demands for democracy.

Deng recognised that the key to ending this erroneous perception of the cause of inflation was to end the profiteering activities of well-connected individuals quickly by decontrolling all prices completely. Deng hence suggested complete price decontrol in 1986⁵⁵, but Hu Yaobang decided to terminate the profiteering in another way, a way that might unseat his political opponents. Hu Yaobang initiated criminal investigations on profiteering by the offspring of several high-ranking cadres who had been at the forefront of the anti-bourgeois liberalism campaign.

Hu Yaobang was attacking from a weak position. He had been increasingly seen as threatening the collective interest of the party. His decentralisation reforms had increased inflation and corruption, and fomented student disturbances; and his latest move of prosecuting the children of high cadres would reveal corruption at the top echelon of the party. All these actions created conditions conducive to the rise of independent organisations (like Solidarity in Poland) to challenge the role of the party. Furthermore, the sharp drop of GDP growth to 9 per cent in 1986 from the 11 per cent of 1983, 15 per cent of 1984, and 14 per cent of 1985 weakened the strongest argument in favour of retaining Hu Yaobang — that political leadership goes to those who provide political legitimacy for the party by engineering impressive economic achievements.

The liberal reform faction had stumbled politically. Its choice was either to launch a decisive attack to unseat the conservatives, like Hu Yaobang's arrests of their children for corruption, or to appease the conservatives and jointly draw up a new compromise reform package. Either course of action was dangerous. The first course ran the risk that in a political showdown conducted in the midst of economic and social chaos, the conservative majority in the party, state and military organisations would unseat the market reformers instead. The second course of action ran the risk that political concessions might signal admission of fatal political weakness and whet the appetite of the conservatives to remove all the market reformers.

The market reformers chose to appease the conservatives. Their concession was to agree to the dismissal of Hu Yaobang as the head of the party. There were three good reasons why the other market reformers sacrificed Hu Yaobang. First, the attacks of the conservatives were centred on Hu Yaobang. His dismissal would not only mollify the conservatives but would also allow the remaining market reformers to pin the recent economic difficulties on Hu Yaobang's "erratic leadership style". Second, Hu's departure would make Zhao Ziyang the first in line to succeed Deng Xiaoping as the pre-eminent leader of China.

Third, Hu Yaobang was much more liberal in his politics than Deng Xiaoping and Zhao Ziyang. For example, at the 6th Plenum of the 12th Party Congress held in September 1986, Hu Yaobang not only questioned the Four Cardinal Principles (formulated by Deng Xiaoping to guarantee perpetual CCP rule of China) as the guidelines for economic policy, he also proposed “expanding creative freedom for intellectuals and pursuing a high degree of political democratisation as a goal, and not merely an instrument, of reform”⁵⁶. Such political stance could not be more different from those of Deng Xiaoping and Zhao Ziyang.

While Deng Xiaoping was willing to be liberal in the economic sphere to whatever degree was needed to transform China into an economic powerhouse he was certainly not liberal in the political sphere. Deng’s instincts were that Western-style democracy in an uneducated, large country with strong regional identities like China would produce social chaos akin to Mao’s mass mobilisation campaigns. Zhao Ziyang was an advocate of “neo-authoritarianism (*xin quanweizhuyi*), a doctrine that stressed the need for strong, centralized technocratic leadership throughout the primary stage of socialism”⁵⁷.

In January 1987, Hu Yaobang was dismissed as the general secretary of the party, and Zhao Ziyang was appointed the acting general secretary. At the 13th Party Congress in October 1987, Li Peng, a Chen Yun protégé, was elected to the Standing Committee and designated the new Prime Minister. A staunch conservative planner, Yao Yilin, who had directed the State Planning Commission since 1980, was also elected to the Standing Committee.

Although Zhao Ziyang was no longer in charge of the day-to-day operations of the state, he still exerted great influence on the direction and implementation of economic policies because he was still the head of the Central Finance and Economic Leaders Group (CFELG), a position he had occupied since 1980. The CFELG is the highest economic policymaking body in China. It is a joint organ of the highest level of policymaking in the party and the government, the Politburo and the State Council respectively, and it usually has five to seven members⁵⁸. So Zhao Ziyang was still in a position to launch major economic initiatives, although he could not expedite them as quickly through the state machinery as when he was also Prime Minister. For example, in January–February 1988, Zhao Ziyang announced (much to the chagrin of the conservative planners) that China would pursue economic growth by “speeding up the development of urban coastal areas to become centres of export-oriented industries”⁵⁹. Specifically, labour-intensive TVEs on the coast, would be allowed to participate more directly in the international division of labour, or, what Zhao called the “great international cycle” (*guoji da xunhuan*)⁶⁰. Zhao Ziyang had obviously understood the secret of dynamic industrialisation in the East and Southeast Asian economies.

The political demise of Hu Yaobang appeared to have further reinforced Zhao Ziyang’s already strong focus on keeping economic growth high. Zhao Ziyang overcame the arguments of the conservatives (notable Prime Minister Li Peng and head of the State Planning Commission Yao Yilin) for tightening credit to reduce inflation. GDP rebounded from the “recession” of 1988, but inflation leaped spectacularly, it went from 6.0 per cent in 1986 to 7.3 per cent in 1987 and 18.5 per cent in 1988.

The very high inflation rate in 1988 was only partially due to Zhao Ziyang’s easy credit policy. As discussed earlier, corruption was inevitable in a dual-price system, and since many of the profiteers were children of high cadres, legal enforcement would inevitably generate tension within the reform coalition. Deng Xiaoping understood all of these

economic and political implications well. Rather than repeating his 1986 tactic of suggesting in internal discussions that prices be freed quickly, Deng went on a public campaign beginning in May 1988 to force the conservative-dominated government to complete comprehensive price reform within three to five years⁶¹. In his words, China would not sustain its high performance unless economic reform “crashed through the price obstacle” (*zhuang jiage guan*)⁶². Deng went as far as to declare in a symposium that the party had decided to proceed with radical price reform, even though the party had not decided to do so!

It must be noted that Deng’s insistence on decisive price decontrol could not have come at a worse time. Prices were already rising at an unprecedented rate. Even Wu Jinglian, one of China’s leading liberal economist and a leading advocate of comprehensive price reform, was against the proposed price reform being implemented at that point in time. While Zhao Ziyang had strong doubts about the wisdom of Deng’s policy initiative, he went along with it, albeit reluctantly.

The outcome was a political disaster for the market reform faction. The news of impending price decontrol in an already overheated economy caused bank runs and panic buying in several cities in July and August 1988. The Politburo responded by voting to deprive Zhao Ziyang of all responsibility in economic policy in August, and, in September, the central committee “put price reform on ice” and ordered the implementation of austerity measures⁶³.

The central planners now finally had their day in the sun since reform had started almost a decade ago.

The Hour of the Conservative Planner

In the view of the central planning faction, China had strayed further outside of the path of balanced economic growth during the preceding ten years of (what the market faction called) “reform and opening”. Specifically, the complaints of the planners were that there was:

- Too much growth in the coastal provinces *vis-à-vis* the rest of the country, hence accentuating regional income inequality and promoting political resentment against the central government; promoting political resentment against the central government.
- Too much growth in the form of small and medium enterprises (particularly TVEs) owned by the local authorities *vis-à-vis* the large state-owned SOEs managed by the central ministries; hence reducing the central planning agency’s ability to set production priorities and to rein in investment to prevent economic overheating.
- Too much investment in processing industries *vis-à-vis* basic heavy industries and infrastructure, hence causing production bottlenecks and appearance of black markets (which sap the political standing of the party).
- Too much dependence on international trade (e.g. Zhao’s promotion of the ‘great international cycle’ theory of economic prosperity) *vis-à-vis* self-sufficiency, hence rendering the country economically vulnerable to the vicissitudes of foreign demand, and politically vulnerable to foreign intervention in domestic affairs (e.g. human rights).

The basic view of the planners was that the decentralisation reforms of the market faction had created unhealthy collusion between local authorities and local enterprises, which resulted in duplication of investments that caused input shortages for the large SOEs that enjoyed economies of scale in production. The goal, according to the new political planners, was to re-centralise to end “feudal lord economies” (*zhuhou jingji*), to empower the “national team of central-plan-central government-large SOEs” to triumph over the “local team of market-local authorities-TVEs” in the political and economic spheres⁶⁴. The ideal economy, in Chen Yun’s view, was one where the plan regulated 80 per cent of the economy and the market “regulated” 20 per cent⁶⁵.

Not surprisingly, therefore, the policy of economic adjustment took the form of re-imposition of price controls over many consumer items, priority acquisition of raw material inputs at plan prices by large SOEs, and the reduction of overall credit growth with large SOEs having preferential access to the smaller amount of credit. Despite the austerity policies that brought GDP growth down to 4.1 per cent in 1989, inflation for that year was still 17.8 per cent. The widening of administrative controls over prices finally pushed inflation down to 2.1 per cent in 1990.

Politically speaking, the planners were walking on a tightrope. Low inflation was politically popular, but low output growth and denial of credit to small and medium enterprises were politically unacceptable if they were sustained. Given that the bulk of the members of the central committee now firmly represented provincial interests, the political trade-off between inflation and growth had changed, since the heyday of central planning in the pre-1958 and 1962-65 periods, to favour growth.

Just when conservatives’ political popularity was subsiding, the Tiananmen tragedy of 4 June 1989 came along to raise their political fortunes to a new high. Hu Yaobang died from a heart attack on 15 April. With the market faction no longer in charge of any key state organisations, the public mourning of the former head of the party provided a politically defensible opportunity for supporters of liberal market reforms and liberal political reforms to mount a show of strength to the reigning Chen Yun protégés. Wreath-laying ceremonies in Tiananmen Square in the heart of Beijing turned into student demonstrations against corruption and inflation. The student strikes quickly spread to a few other major cities. Over time, the students expanded their demands to include democratisation of political life, termination of the leftist campaigns against bourgeois liberalism and spiritual pollution, and higher pay for intellectuals.

The Li Peng government, worried about the possible escalation of the student protests into a Polish-style uprising, decided to intimidate the students into submission. On 26 April, the *People’s Daily* published an editorial questioning the patriotism of the students, suggesting the manipulation of the students by a small anti-party group, and recommending the adoption of a hard-line by the government against the turmoil. The threat backfired. The number of student strikers increased, the strikes spread to more cities, and workers started joining in the protests. The students were now in full-time occupation of Tiananmen Square, and in full view of the world thanks to international media having converged upon Beijing to cover a forthcoming visit by Soviet President Mikhail Gorbachev.

Gorbachev departed Beijing on 18 May, and martial law was declared the next day. The public responded with a great show of support for the students, by giving them food and blockading troops from entering the city. The authorities, alarmed by the stronger and larger opposition that greeted each of their actions, decided that a major show of force was necessary to restore public order. The result was the 4 June Tiananmen Square tragedy.

On 24 June, Zhao Ziyang was removed from all of his party posts, and Jiang Zemin (the party secretary of Shanghai who was untainted by the decision to re-take Tiananmen Square forcefully) was selected to be the new general secretary. Hu Qili, a Hu Yaobang protégé, was also removed from the Standing Committee of the Politburo and was replaced by Song Ping (a former head of the State Planning Commission) and Li Ruihuan (the reformist mayor of Tianjin).

The important point to note in these personnel changes is that they only strengthened the hand of the conservative faction, but did not result in one of its members being appointed to the top party position, even though June 1989 was a chaotic time and the conservative faction stood for law and order. This point is significant because it shows that even at the height of its political power, the economic and political agenda of the conservative faction could not mobilise enough support from the top and middle echelons of the party to take full control of the party.

The reason for the tepidness of many central committee members towards the conservative faction is the same one, although milder, that propelled the student demonstrations in 1986 and 1989, and energised Beijing residents to support the students in 1989. The information set of intellectuals and literate dwellers in large cities had changed immensely after ten years of market reform and international integration. In their eyes, the impressive economic development of the market economies in East and Southeast Asia and their convergence to the living standards of the United States and Western Europe combined with the rapid growth of China under partial market reforms had totally discredited central planning. Furthermore, the political evolution of authoritarian Taiwan and South Korea towards forms of political democracy that closely parallel those of the richest countries convinced many Chinese that the democratic centralism that had accompanied central planning was an anachronism. The outcome was that, by 1989, most members of the party and state bureaucracies, who did not directly benefit from the political patronage of the leading conservatives, were highly sceptical about, one, central planning and self-sufficiency being the best answers to China's poverty, and, two, the political viability of the conservative faction after things had calmed down. The 1979 reversal of the Maoist verdict that the 1976 Tiananmen demonstration was an anti-party, unpatriotic action was still fresh in their minds.

A few years earlier, Deng Xiaoping had defended his policy of opening to the world by pointed out that "merely because a few flies might come in through an open window would not justify closing the window". What Deng must have foreseen, but deemed it wise not to emphasise, was that Hegel's owl of Minerva might also fly in, and roost there because of its preference for dark (unenlightened?) places⁶⁶. In short, by opening China to the world, Deng had guaranteed that modified Stalinism would become over time unacceptable to the bulk of the party. The threshold of rejection was certainly reached by the time of the June 1989 meeting of the central committee which chose the economic centrist, Jiang Zemin, to be the new secretary-general rather than one of the candidates favoured by the conservative faction⁶⁷.

The scepticism of many central committee members towards the economic and political programmes of the conservatives was soon confirmed by the sudden tectonic changes in Eastern Europe. The formation of the first Solidarity government in Poland in August 1989 was followed in rapid succession by the near-apostatic transformation of the Hungarian Communist Party to the Hungarian Socialist party in October 1989, the velvet revolution in Czechoslovakia and the fall of the Berlin Wall in November 1989, the overthrow of Nicolae Ceasescu and the Romanian Communist Party in December 1989, and the renaming of the Bulgarian Communist Party to the Bulgarian Socialist Party in early 1990.

All of these external events made it clear that communism was not inevitable, and that it was also reversible. However, the CCP was quick to point out that communism in Eastern Europe was externally imposed by the Soviet Union and not a home product as in China. So Chinese communism, unlike East European communism, would endure. The fact that the Soviet Union did not fall along with the Eastern European dominoes appeared to support the CCP's argument.

The combination of regional economic interest and intellectual rejection of central planning by most bureaucrats, especially those outside Beijing, transformed passive resistance to more active resistance against the re-centralisation measures of the Li Peng government. The 8th Five-Year Plan that was finally adopted in December 1990 was a pale imitation of the hard-line first draft. The attempts to collect more revenue from the provinces were repulsed, and monetary policy was loosened at the insistence of the coastal provinces.

In the end, the conservative faction was not able to roll back significantly the decentralisation and internationalisation reforms of Hu Yaobang and Zhao Ziyang. It only succeeded in stopping new major reform initiatives. Economic reform in China was no longer an enterprise that had to be led from the top, and that had to be defended by top leaders. The new economic interest groups (e.g. provincial party secretaries and SOE managers) created by the decade-long market reform, the more sophisticated information sets enabled by international interaction, and the collapse of central planning in Eastern Europe had spawned and widened a pluralistic economic reform lobby in China. What was now needed was a Chinese Lech Walesa to forge the disparate elements of the economic reform lobby into a pro-reform political coalition. This turned out to be the final path-breaking role for Deng Xiaoping.

Deng Xiaoping's Last Journey

The seemingly unprecedented large political earthquakes in Eastern Europe proved to be just the minor pressure-relieving tremors that precede a truly, cataclysmic earthquake. The collapse of communist rule in the Soviet Union, and its disintegration into 15 independent nations in 1991 caused a Kuhnian paradigm shift among most of the remaining party leaders who still favoured central planning. Deng Xiaoping seized the moment to act decisively.

Like Mao Zedong before him who went to Shanghai in 1965 to launch the Cultural Revolution, Deng Xiaoping went the extra miles to his creation, Shenzhen, the showcase city of capitalism in China, and broke new ideological grounds in a stunning series of speeches⁶⁸:

“The fundamental difference between socialism and capitalism does not lie in the question of whether the planning mechanism or the market mechanism plays a larger role. [The] planned economy does not equal socialism, because planning also exists in capitalism; neither does [the] market economy equal capitalism, because the market also exists in socialism. Both planning and market are just economic means.”

“At present, some rightist things are affecting us, and so are some ‘leftist’ things. However, the ‘leftist’ things are deep-rooted ... ‘Leftist’ things have done terrible harm to our party in the past ... Socialism may be ruined by rightism, but should mainly guard against ‘leftism’ ... The opinion which equates reform and opening to ushering in and developing capitalism, and which holds that the danger of peaceful evolution mainly comes from the economic field, precisely represents ‘leftism.’”

Deng’s speeches broke the ideological logjam that had been holding back the rush toward a normal market economy. The tidal wave of market reform that swept the country baptised Li Peng and other central planners in the Standing Committee, and turned them into born-again reformers. In the 14th Party Congress held in October 1992, the CCP declared that the final objective was the establishment of a socialist market economy with Chinese characteristics. Successive plenums following that declaration identified the ambiguous property rights of SOEs to be an important reason for their poor performance, and recommended that the SOE problem be solved through “holding on to the largest SOEs, and letting the small SOEs go” (*zhua da, fang xiao*). Of course, the fact that the proportion of loss-making SOEs accelerated in the 1992-97 period made their privatisation more attractive to the party.

In the 15th Party Congress held in September 1997, the CCP under the leadership of Jiang Zemin spelled out the meaning of *zhua da, fang xiao*:

“We shall convert large and medium-sized state-owned enterprises into standard corporations according to the requirements of ‘clearly established ownership’, well-defined power and responsibility, [and] separation of the enterprise from administration ... [In these enterprises] the state will enjoy owners’ equity according to the amount of capital it has put into the enterprise and bear limited responsibility for the debts of the enterprises, [which] will operate according to law, responsible for their own profits and losses ... We shall also quicken the pace in relaxing control over small state-owned enterprises and invigorating them by way of reorganization, association, merger, leasing, contract operation, joint stock partnership or sell-off.”

Equally important, the CCP also declared that the private sector was “an important component part of China’s socialist market economy [and that its] legitimate rights and interests” should be protected by law.

It must be mentioned that the staunchest members of the conservative faction were of the revolutionary generation. By September 1997, Chen Yun, Peng Zhen, Wang Zhen, and Li Xiannian were all dead⁶⁹. To paraphrase Paul Samuelson’s famous remark that “true progress in economics is made funeral by funeral”, one could say that recent progress on the political acceptance of China’s convergence to a normal market economy has been enabled funeral by funeral. While the conservative planners left an economic policy legacy that would diminish over time, the opposite would be true for the economic policy legacy of Hu Yaobang and Deng Xiaoping (who died in February 1997). The first proof of this was the announcement of radical reform of the state sector at the 15th Party Congress.

IV. ECONOMICALLY VIABLE ENTERPRISE REFORMS?

The Experimentalist School has hailed China as the pioneer on two economic fronts *a)* improving SOE performance, and *b)* showing that collectively owned enterprises are efficient economic entities. The policy implications from these two innovations are, respectively, that there is no economic reason to privatise SOEs⁷⁰, and that localised socialism is the third way between capitalism and the centralised socialism of the Soviet Union⁷¹.

The C-school, on the other hand, contend that China's SOE reform was a failure, and that the reason for China not accepting explicit privatisation of its SOEs until recently was due mostly to political reasons rather than to satisfaction with their economic performance. This school also contends that the proliferation of collectively owned rural enterprises in the 1980s was caused by political constraints on the establishment of private enterprises rather than by the inherent dynamism of localised socialism.

Reforming the SOE Sector

China's reform of its state enterprise sector has been truly incremental and experimental. Reforms have typically taken the form of new practices being allowed for a small number of SOEs, and then being more widely adopted over time. Until the 15th Party Congress in September 1997, market socialism was the guiding force behind SOE reform. This explains why the general reform direction had been the steady expansion of the operational autonomy of the SOEs with almost no serious discussions (until recently) of privatisation as a reform option. From 1979 onwards, managers received in piece-meal fashion the rights to make decisions about bonuses, how and what to produce, pricing, marketing, and investment. In parallel with this expansion of managerial autonomy was the steady decontrol of prices; with the prices of final goods being gradually liberalised since 1979, and the prices of inputs liberalised via the dual-track system since February 1985.

None of the preceding SOE reforms fundamentally altered the ownership structure of the enterprises, though they did significantly affect the control structure. Most Chinese economists in 1979 advocated the market socialism type of SOE reform, most notably, Jiang Yiwei (1979), an influential advisor to Zhao Ziyang. Dong Fureng's (1979) identification of ownership reform as the key to enterprise reform was generally ignored (partly, perhaps, because of fear by many that this suggestion would not be tolerated politically.) However by 1986, many Chinese economists had concluded that SOE reform had failed, and came around to Dong Fureng's analysis. For example, Li Yining (1986b) and Jiang Yiwei (1987) advocated shareholding as a key to SOE reform.

It is most interesting that assessments of China's above decentralising reforms on SOE performance have differed widely, especially among non-Chinese economists. For example, Jefferson and Rawski (1994, pp. 58) have concluded that:

“ ... reform has pushed China's state-owned enterprises in the direction of 'intensive' growth based on higher productivity rather than expanded resource consumption ..., we observe a consistent picture of improved results — higher

output, growing exports, rising total factor productivity, and increased innovative effort — against a background of gains in static and dynamic efficiency that reflect the growing impact of market forces.”

Whereas, the Vice–Premier Zhu Rongji announced in 1996, after four years of double digit economic growth, that:

“The current problems of SOEs are: excessive investments in fixed assets with very low return rates, resulting in the sinking of large amounts of capital; low sales–to–production ratio giving rise to mounting inventories. The end result is that the state has to inject an increasing amount of working capital through the banking sector into the state enterprises.”⁷²

Vice–Premier Zhu’s verdict represents the dominant view of Chinese economists and officials throughout the reform period — a view shared by many foreign economists. But, according to Naughton (1995), this difference in assessment from that of Jefferson and Rawski (1994) is the result of ignorance on the part of Chinese observers and of ideological prejudice on the part of some foreign observers:

“Focusing on profitability, [state bureaucrats] see the erosion in state sector profits as a profound crisis of the state sector. Without good measures of total factor productivity, they conclude that state sector performance is deteriorating. Foreign observers, hearing the cries of alarm from the state planners, shake their heads knowingly as they perceive still further evidence that state ownership is intrinsically inefficient. Neither party sees that the difficulties are the result of an ultimately beneficial transition to a different type of economy, and are entirely compatible with gradually improving efficiency.”

We disagree. The fact of the matter is that improvements in the technical performance of SOEs is an unsettled issue⁷³. There is also little dispute that efficiency improvements in the SOE sector are several times lower than those in the TVE sector. Furthermore, the decentralisation reforms has allowed the SOE employees (particularly, the managers) to strip the assets of the enterprises⁷⁴. For example, in December 1995, the State Administration of State Property reported that asset–stripping in the SOE sector “has been about 50 billion yuan [annually] since the early 1980s”⁷⁵ — which meant that the cumulative loss of SOE assets in the 1983–1992 was equivalent to about 34 per cent of the net value of fixed assets in the SOE sector in 1992.

The results of China’s SOE reforms, in short, have not been impressive. The decentralisation reforms had produced only one big change, and a negative one at that. They provided the managers with the means to embezzle funds on a large–scale.

The Failure of SOE Reform and Its Radicalising Effects

While the continued inefficiency of the SOE sector was merely disappointing to the Chinese government, the mounting losses and the acceleration of asset stripping in the SOE sector were truly alarming to the Chinese government. The financial losses and the asset stripping represented political time bombs. The financial losses tended to destabilise the macroeconomy by putting pressure on the central bank to expand the money supply, and asset stripping tended to fuel social outrage at corruption. It is instructive to note that the original demands of the 1989 Tiananmen demonstrators were for reductions in inflation and corruption.

Hence, not surprisingly, there was a fundamental change in official philosophy about SOE reform at the end of 1993 in the wake of a drastic worsening of SOE losses despite record economic growth in 1992 and 1993. The Central Committee of the CPC identified the ambiguity of property rights to be an important cause of the unsatisfactory performance of SOEs, and decided that:

“Large and medium-sized State-owned enterprises are the mainstay of the national economy; ... [for them,] it is useful to experiment with the corporate system ... As for the small State-owned enterprises, the management of some can be contracted out or leased; others can be shifted to the partnership system in the form of stock sharing, or sold to collectives and individuals.”⁷⁶

By the end of 1995, the above decision had been formulated into the slogan of “holding on to the large SOEs, and letting the small ones go”, and, in September 1997, the party finally decided to adopt shareholding as the chief means of reforming the state sector.

There can be little doubt that the Chinese leadership recognises the increasingly serious economic and political problems created by the agency problem innate in the decentralisation reforms of market socialism. This is why the 15th Party Congress moved decisively on the privatisation front. China has absorbed the positive international experience with privatisation of SOEs, and is now converging to the international norm of enterprise structure.

The TVE Phenomenon

The foundation for collective-owned rural industrial enterprises was laid during the decade-long Cultural Revolution when the official emphasis on self-reliance and the breakdown of the national distribution system caused the rural communes to expand their non-agricultural activities. These non-agricultural activities were grouped into production units now called township and village enterprises (TVEs) as the commune system began to dissolve in 1979. The concern for rural underemployment and local development has led to steady liberalisation of the rules governing the formation of TVEs; and, since 1984, the terms of approval and supervision of TVEs have varied greatly across regions.

Prior to 1984, TVE referred to township-owned (*xiang-ban*) and village-owned (*cun-ban*); and from 1984 onward, TVE statistics also include joint-owned (by several persons or families, *lian-ban*) and individual-owned (by one person or family, *geti*)⁷⁷. However, because most academic discussions on the ownership structure of TVEs implicitly use a narrower definition that covers only the enterprises that are registered formally (and increasingly falsely) as township-owned and village-owned⁷⁸, in this paper the term “non-collective TVEs” is used to refer to rural enterprises that are not registered as collective-owned.

Given the varieties of TVEs, the vagueness about their ownership and control, and their evolving nature, it is therefore natural that many discussions on the character of TVEs, especially when the time period and geographical location are not clearly specified, have resembled the fabled conversation among the three blind men who just had their first contact with an elephant. For example, Nee (1996) regarded TVEs as informal joint ventures between the state and the private sector, often with “extensive informal privatisation of collective-owned assets and firms”, whereas Walder (1995) viewed TVEs as “under a form of public ownership no different from the large urban state sector”. Peng (1992)

emphasised the “semi-private” nature of TVEs to explain their operational autonomy, while Oi (1995) accented a state-centred view where TVEs are the production units in “a large multi-level corporation” managed by the county-township-village hierarchy⁷⁹.

Explaining the TVE Ownership Form: Economic Logic or Political Logic?

It must be emphasised that the TVE ownership structure is highly unusual by international standards. In most countries with rural industry, such as Indonesia and Thailand, ownership of small enterprises is private, often within a family. By contrast, TVE ownership is collective, at least officially. Some scholars have argued that collective ownership reflects deep Chinese cultural patterns, Weitzman and Xu (1994). However, this “co-operative culture” hypothesis appears to be refuted by the dominance of private enterprises in rural Taiwan, a Chinese province.

Other scholars have said that collective ownership is an effective way to raise capital funds for rural enterprise and to reduce the principal-agent problem by shortening the supervision distance, Oi (1995) and Walder (1995). The Experimentalist School has used these reasons to interpret the TVE ownership structure as a good adaptation to market failures caused by China’s underdeveloped markets for factors of production. According to Naughton (1994):

“Banks are ill-equipped in the early stages of transition to process small-scale lending applications and assess risks. Local government ownership in China played a crucial role in financial intermediation. Local governments could better assess the risks of start-up businesses under their control ... and serve as guarantors of loans to individual TVEs.”

Some members of the E-school have even interpreted the TVE record as definitive proof against the conventional wisdom that private ownership is the natural ownership form of small scale enterprises, and argued that what mattered for efficiency is not ownership but competition in product and factor markets; Nolan (1993).

The E-school’s functionalistic explanation of TVE ownership form, especially of its emphasis on the state’s superiority in financial intermediation is dubious. Taiwan’s small and medium private enterprises exhibited dynamic growth in the 1960-1985 period even though they were heavily discriminated against by the (wholly state-owned) banking system because informal financial markets (curb markets) appeared to cater to their needs, Shea and Yang (1994). The power of market forces (when tolerated by the local authorities) to induce financial institutional innovations was also recently seen in Wenzhou city in Zhejiang Province when economic liberalisation began in 1979. Liu (1992) reported that:

“Ninety-five per cent of the total capital needed by the local private sector has been supplied by ‘underground’ private financial organizations, such as money clubs, specialized financial households and money shops...”

An adequate general theory for TVE ownership structure will have to be based primarily on political considerations. Private ownership was basically prohibited in many areas until after Deng’s *nanxun* in 1992. Kate Zhou (1996) noted that:

“the social and political environment throughout the reform period was hostile to private businesses ... The government did not give legal recognition to *siying* [private enterprises with more than five workers] until 1987” (pp. 121)

Therefore, collective ownership of rural industry arose as the primary response to the profitable niches created by central planning because other forms of ownership were discriminated against, if not prohibited. Using the term “non–collective TVEs” for private enterprises i.e. TVEs not registered as collective–owned, Zhang (1993) reported that:

“in virtually all aspects relating to local governments, the non–collective TVEs tend to be unfavorably treated ... [compared to] their collective counterparts. Areas in which local governments appear to have discriminated against non–collective TVEs include access to bank credits, to larger production premises, to government allocation of inputs and energy, to government assistance in solving technical problems and for initiating joint ventures and so forth. In the field of taxation and profit distribution, there is evidence that non–collective TVEs run a greater risk of being excessively levied, and that local governments tend to treat the non–collective TVEs more arbitrarily than do the collective ones.”

In short, the “market failures” identified by the E-school are not caused by inefficiencies intrinsic to a private market economy (like externalities and public goods), these so–called market failures are actually created by ideologically–motivated constraints imposed by the state. Specifically, the banks have extended more loans to TVEs than to private enterprises because of state directives, and not because TVEs are intrinsically more efficient or because of the local banks’ recognition that the local governments were better assessors of risks than themselves, Chang and Wang (1994)⁸⁰.

The result of this ideologically–based discrimination against private enterprises was that many private enterprises registered themselves as collectively owned, a phenomenon commonly referred to as “putting on a red hat (*dai hong maozi*)” or as “hooking on to a politically–correct unit (*guahu*)”. The *China Daily*, 4 November, 1994, reported that:

“hundreds of thousands of private companies have registered as branches of publicly–owned units on the condition that they pay money to their so–called owners ... [because private companies face] complicated registration procedures, heavy levies and less preferential treatment than State firms [in fund raising and fund use. For example, one] private company had to write 46 receipts of 10 000 yuan each for goods worth 460 000 yuan because non–state firms were only allowed to issue bills under 10 000 yuan.” (“Private firms jump to take ‘red caps’ off”.)

The economic factor that is germane to a general TVE theory is not underdeveloped markets as argued by Naughton but the low labour mobility in the countryside, which resulted largely from the household registration system that tied the peasants to the land. Community ownership was plausible because the community members expected to remain in the same place indefinitely, and there was also no complicating factor of inward migration.

The veracity of a (primarily) politically–based and (secondarily) mobility–based explanation for collectively–owned rural enterprises is supported by the direction that the TVE ownership form has taken since 1992 when discrimination against private ownership was reduced in order to relieve the rural unemployment caused by the 1989–91 austerity policies. Many TVEs began taking off their “red hats” — albeit with difficulty in many cases:

“As China heads toward a market economy, an increasing number of private companies are no longer feeling the need to register as “red cap”, or collectively–owned ventures ... [because the] difference in preferential treatment between private and public units has been narrowed ... But there is a problem. The collective

units are now arguing that private firms could not have developed without their help. As the so-called 'owners' of the companies, the State firms usually ask for high compensation for the 'divorce' or ask the companies to merge with them." ("Private firms jump to take 'red caps' off", *China Daily*, 4 November, 1994.)

An additional factor for the present movement among TVEs to "clarify" their property rights is that the capacity expansion of many coastal TVEs in southern China has forced them to rely increasingly on migrant labour from the poorer provinces. The original inhabitants in these richer provinces want to prevent the new residents from having an automatic share in the dividends of the collective-owned enterprises, and so some areas have converted the collective TVEs into "shareholding co-operatives" by corporatising the TVEs and dividing the shares among themselves. The fact that the government has not clamped down on this de-collectivisation of TVEs has been viewed as implicit approval, and this has accelerated the conversion of TVEs to shareholding co-operatives.

Different Interpretations on Recent Enterprise Policy: Which is the Cart, and which is the Horse?

It must be stressed that the recent steps to privatise state enterprises and to transform the TVEs into shareholding co-operatives are interpreted very differently by the Convergence School and the Experimentalist School. The C-school regards both developments to reflect the triumph of economics over politics. The political of the legitimacy of the Chinese Communist Party has come to rest increasingly on its ability to deliver high economic growth, and so the survival of the party necessitated that good economics be practised.

The Experimentalist School, on the other hand, sees recent developments on the enterprise front as the triumph of politics over good economics. According to Louis Putterman (1995) "some form of market socialism could be [economically] viable", but global and Chinese political trends favour the growth of private enterprises:

"[The] failure of the Soviet model, the no more experiments attitude that has followed that failure throughout the ex-Communist world, collapse of Communism as a world movement, rapid private economy growth in neighboring countries, and burgeoning consumerism and the priority attached to economic goals in China, make long-term commitment to the socialist market concept appear doubtful", (Putterman, 1995, pp. 1061-2).

The question is which school is putting the cart in before the horse? In the next section, it will be argued that it is the E-school.

V. CONCLUSIONS

It's Not Just Economics, Stupid⁸¹

The CCP elite in 1978 recognised that it had to conduct its intra-party debate under the self-imposed constraint of compromise. The Cultural Revolution experience made clear that an intense factional struggle could generate political instability, social chaos and economic stagnation, outcomes that would undermine the legitimacy of the party and result in collective suicide. Just as in the Soviet Union after the departure of Stalin, the leaders of the key factions (mass-mobilisation-oriented Maoists, plan-oriented Stalinists, and market-oriented totalitarians) in the CCP have assiduously practised the art of political compromise, and avoided conflicts that sought to annihilate the other side. The deposed Maoist head of the party, Hua Guofeng, was in 1999 still a member of the central committee in recognition of his willingness to play by the rules. In keeping with the same rules, Zhao Ziyang, the deposed market-oriented head of the party, still keeps his party membership, and has not been brought to trial for encouraging the Tiananmen Square demonstrators in 1989 (as has been alleged).

The two main competing factions since 1981 — the conservative reformers and the liberal reformers — have vastly different ideas on the ideal organisation of the economy, and on the nature of economic mechanisms. The bird-cage ideal of the conservative planners necessitated that technocrats be not only technically brilliant but also be all sacrificing and altruistic. This morality requirement for the success of the conservative economic programme meant that ideological campaigns must be conducted constantly to inculcate altruism and caution against capitalism. Hence the chief barriers to economic growth, according to the conservatives, were “bourgeois liberalism” and “spiritual pollution from the decadent West”.

The liberal market reformers, on the other hand, regarded the chief barriers to economic growth to be the suppression of the market and the isolation from the international economy. Since the policy debate had to be conducted in Marxist terminology, and since Marxist social theory put the market economy as the stage between feudalism and communism, the liberal reformers have argued that China was in the primary stage of socialism, and that development of the productive forces at the primary stage required markets to mobilise and utilise resources fully. Hence, the chief barrier to economic growth, according to the liberal reformers, was the persistence of feudalistic mentality that prevented the fast emergence of a market economy in China.

Given the vastly different views of both factions, the resulting compromise economic strategy showed a schizophrenic character that, *ex post*, could be interpreted as a strategy of deliberate incremental reform. From 1977 to 1991, Deng Xiaoping played the important role of forging compromises between the two camps. He straddled both sides of the debate skilfully, denouncing both “bourgeois liberalism” and “feudalism” harshly in the same speeches, while pushing economic deregulation and economic opening forward as far and as fast as his conservative colleagues could tolerate. When Deng preached the importance of maintaining stability at the same time, he also preached the need for reforms to be carried out at a faster pace, e.g. “reformers should not walk like women with bound

feet”, and “reformers should crash the price barriers by decontrolling prices comprehensively and rapidly”. Deng agreed with the conservatives on the need to prevent spiritual pollution, but he qualified his support with the observation that a few flies might fly in through an open window but this would not justify keeping the window closed. He supported political campaigns against capitalist tendencies as long as they did not intrude sufficiently into the economic sphere to cause a significant slow-down in growth.

Herein lies the primary reason for the slow, gradual, incremental and evolutionary nature of China’s economic reform: the existence of two competing economic programmes. As in most situations of this kind in other countries of the world, the resulting economic policies drew upon both programmes. Farmers were given land to work as they pleased, but the land was to be redistributed after 15 years. Deep integration into the world economy was allowed, but only for firms in the four Special Economic Zones, and these zones were restricted to be located in the south, far away from Beijing. Rural residents could establish industrial enterprises outside of the central plan but these enterprises had to be collectively owned.

Dual track pricing was established for many goods. Firms still had to deliver specified amounts of output to the state at predetermined prices, but output beyond their quotas could be sold in the open markets. Firms had to sell a proportion of their export earnings to the state at the official exchange rate but could dispose of the rest in the “swap market for foreign exchange” at a parallel exchange rate that reflected market forces and usually much higher than the official rate. Whenever political circumstances allowed, economic deregulation was broadened, allowing many markets to converge to free market conditions. For example, the exchange rate has been unified in January 1994; numerous trade and development zones with varying subsets of SEZ privileges have been established along the coast; and price decontrol is almost complete.

Even if the liberal reformers in 1978 had sufficient leeway from the conservatives to reform the inherited Maoist economy to the full extent of their market-oriented programme, they would have been unlikely to have undertaken rapid, comprehensive repudiation of Maoist policies and the command economy administrative structures. There were two reasons for holding back in this hypothetical situation — one political, and the other intellectual, with the political reason being by far the more important one.

The political fact is that wholesale repudiation of the economic policies of the preceding 30 years would, in the eyes of the populace, amount to a confession of total economic incompetence on the part of the CCP. Such an admission would naturally raise the destabilising question of why the party should continue to rule, or, at least, raise the troublesome question of why the same people (Deng Xiaoping included) should to stay in charge of economic management.

There was an institutional dilemma. The new national leaders who emerged in 1978 had a new policy agenda, but these new national leaders did not come from a new political party as was to be the case in Poland in 1989, and in Russia in 1991. The liberal reformers recognised that a total absence of political continuity could seriously damage their own political credibility and legitimacy. It was therefore important that economic reforms be implemented within the facade of existing party ideology in order to help preserve the monopoly political position of the party.

The second reason why the liberal reformers in 1978 might have hesitated in implementing decisive reforms on a grand scale even, if they had been able to was because some of the reformers lacked of knowledge with the reform experiences of other countries, the workings of advanced capitalist market economies, and the economic mechanisms

behind the dynamic growth of its capitalist East and Southeast Asian neighbours. The status of the Soviet Union, the mother of all centrally planned economies, as one of the two world powers in 1978, lent credence to the conservatives' case that ingenious tinkering with the central plan mechanism might be able to generate sustained high growth. The bird-cage economy ideal was not yet recognised to be a bird-brain idea, mainly because of the lack of definitive knowledge in 1978 China about the growing economic crises in mother Russia and reformist Eastern Europe.

It is important to emphasise that political considerations constituted the over-riding reason for China's incremental reform programme:

- i)* The existence of a large cohesive group of rehabilitated cadres who supported Chen Yun's insistence on central planning being the primary mechanism for resource allocation; and
- ii)* The recognition by the liberal reformers that immediate abandonment of socialist economic policies would undercut the legitimacy of the communist party that they were leading.

The "knowledge gap" of the liberal reformers was only a secondary and temporary reason for China's incremental reform process. There were many Chinese economists in 1978 who knew that economic reforms had to go beyond price deregulation to ownership reform. For example, in 1979, Dong Fureng, the director of the Institute of Economics at the Chinese Academy of Social Sciences (the premier think tank in China), argued that state ownership was inherently incompatible with economic flexibility and efficiency, and he advocated ownership by workers (i.e. insider privatisation)⁸². Furthermore, in the first three years of the reform, hundreds of mid-level Chinese officials, who were expected to rise to high positions in the future (e.g. Jiang Zemin), were sent on study tours to Japan, South Korea, Singapore, Western Europe and North America. The affluence of these countries, especially of their Asian neighbours, combined with an improved understanding of the reform experiences in other developing countries brought many Chinese officials to the conclusion reached over 300 years ago by the Meiji reformers in Japan that convergence to the economic institutions of Western Europe and North America was the key to economic prosperity.

Deng Xiaoping, by choosing not to confront his conservative colleagues prior to the implosion of the Soviet Union in 1991, on the stark choices in economic reform kept the party together, and hence allowed the party to maintain power despite the immense social and political changes. The political cost of Deng's strategy of simultaneously accommodating his conservative colleagues, mostly in rhetoric, and pressuring his liberal protégés to implement marketisation and internationalisation faster, was borne by his two designated successors, Hu Yaobang and Zhao Ziyang. In the three-year period after the fall of Zhao, the cumulative political developments unleashed by the economic reforms (like the rise of independent provincial economic power, and the appearance of quasi-private enterprises), plus the collapse of communist rule in Eastern Europe and the Soviet Union had changed the political landscape sufficiently in his favour that Deng could challenge his conservative colleagues and impose his vision of a private market economy upon them.

The Chinese economic reform process is captured by a well-known joke about Deng's political stratagems, and his relations with his protégés. Hu Yaobang and Zhao Ziyang accompanied Deng to a meeting with President Ronald Reagan and Secretary-General Leonid Brezhnev. The three groups decided to go for a drive in the country, each group in its own bus. When the buses reached a fork in the road, the American bus turned right,

and the Soviet bus turned left. Hu Yaobang, the driver of the Chinese bus, turned and asked Deng (the fabled backseat driver) for instructions. Deng replied “Turn on the left signal, and turn right”. This reply captured the essence of Dengist accommodation of the conservative faction in his reform coalition, a practice that respected the post-Mao consensus on compromise.

The reform dynamics is captured in the second part of the joke. A fly (nicknamed “spiritual pollution”) flew in through the open window and into Hu Yaobang’s eye, causing Hu to brake suddenly and hit his head against the steering wheel — killing Hu instantly. Deng immediately ordered Zhao Ziyang into the driver seat to get rid of the dead weight of Hu, and to catch up with the American bus. This replacement showed the political wisdom of Dengist practice: the consequences of accidents are borne by the driver not the backseat driver⁸³. Policy mistakes committed by the backseat driver are passed as implementation mistakes committed by the driver.

It has been often pointed out that the economic liberalisation and economic opening set in motion processes that supported and radicalised the original economic reform package. However, it is even more important to point out that these were not self-sustaining processes that were impossible to stop or reverse. The economic reforms did not initiate an irresistible virtuous cycle; to conclude otherwise is to engage in specious retrospective determinism. Kate Zhou (1996), for example, concluded that there was nothing inevitable about the process of agricultural de-collectivisation that went beyond the officially sanctioned “devolution of responsibility to production team (*baochan daoizu*)” to the explicitly banned “devolution of responsibility to household (*baochan daohu*)” because:

“Deng could certainly have stopped the movement by military force had he chosen to do so.” (p. 70)

Susan Shirk (1993) and Yasheng Huang (1996), among others, have argued that the economic reforms contributed to political decentralisation by putting resources into the changes of local governments, and that this new political strength of the regions, in turn, made it impossible for “the central planners to roll back reforms completely in the wake of the [1989] Tiananmen crackdown”⁸⁴. It is important to refrain from using episodes like this to argue that incremental reforms tend to create virtuous cycles. The opposite could have happened if political circumstances in China had been different, Huang (1995). The regional economic powerhouses created by the decentralisation reforms could have led to national disintegration, instead.

Retrospective determinism provides a convenient device to organise the chain of factors responsible for a particular set of outcomes, but it would be wrong to resort to it in many cases. The present review of Chinese economic history is replete with examples where individuals had the choice to change history. There was no necessity for Mao Zedong to allow the Cultural Revolution to totally crush those who disagreed with his policies. There was no barrier to Marshal Ye Jianying’s taking over political leadership after the arrest of the Gang of Four in 1976. There was no reason why powerful water canons and tear gas could not have cleared Tiananmen Square equally well in June 1989.

The case against retrospective determinism is also supported by the fact that external shocks had been important in determining the direction and pace of China’s economic reforms. The rise of Solidarity in Poland in 1980 convinced the party leadership that political stability is conditional upon satisfactory economic growth. Furthermore, the implosion of Eastern Europe and the Soviet Union in 1990-1991 destroyed the credibility of the

conservative reform programme, otherwise, the planners would, most likely, over time, have rolled back key elements of Zhao Ziyang's reform, and restored their much-cherished "proportionate pattern of growth". At the minimum, the conservatives would hold the line against further major economic deregulation and opening.

There is, in short, nothing inevitable about economic reforms moving forward on their own momentum once some reform measures have been implemented. There have been just too many cases of aborted economic deregulation and economic opening for the virtuous cycle hypothesis to be credible, e.g. Egypt and Turkey in the 1980s, and (possibly) India in the 1990s.

The Debate between the Experimentalist School and the Convergence School

In contrast with the explanation of China's gradual reform process as being the product of political accommodation, many China scholars in the E-school have advanced the alternative explanation that the cause for gradualism was economic experimentation. China's policy makers, allegedly ignorant of how to reform a command economy, engaged in controlled experimentation with a wide array of policies at many sites, and then propagated the best techniques from the experiments to other parts of the country. If the E-school is correct, then the observed process of convergence to standard market norms in China is an accidental outcome of China rediscovering the economic wheels of modern capitalist economies. Such an accidental outcome is not impossible, of course, it is just implausible. It is hard to believe either that the Chinese leadership has been oblivious to the causes of the successful economic development of its neighbours, or that it has not been influenced by the knowledge of their experiences.

These two broad competing interpretations of China's growth have vastly different implications for future reforms in China and elsewhere. The Experimentalist School would advise China to continue liberalisation in a tentative, incremental manner because this might minimise the cost of any single policy experiment going awry. The E-school would encourage Eastern Europe and the former Soviet Union (EEFSU), North Korea and Cuba to trust the "induced innovations" mechanism to spawn the type of economic system that best suits each country's circumstances. The crux is to create country-specific virtuous cycles through gradual marketisation and gradual internationalisation of these economies. The E-school's preference for an evolutionary outcome rests on its perception that another important cause for the contrasting EEFSU-China outcome is the imposition of "top down" (exogenous and dictatorial) reforms by the EEFSU governments versus the acceptance and propagation by the Chinese government of "bottom-up" (endogenous and consensual) reforms initiated and tested by the masses; Chen, Jefferson and Singh (1992), and McMillan and Naughton (1992).

In contrast, the Convergence School recommends that China implements a Meiji-style wholesale adoption of key market institutions from abroad, and modify them through practice. The bold assumption here is that the normal economy, defined within broad institutional limits, is characterised by market-based transactions between private agents. With this preconception of normalcy, the C-school holds that China today has more to learn from EEFSU rather than vice-versa; particularly in the establishment of market-based property rights regimes, and the prudent marketisation of the banking system. The C-school's message to North Korean and Cuban reformers is that China's dual-track

strategy is an option only if the economy is dominated by subsistence peasant agriculture, and that China has achieved the best results in the sectors where marketisation has gone the farthest⁸⁵. North Korea and Cuba would serve themselves well by adopting immediately the economic institutions of South Korea and Taiwan, respectively, rather than attempting to re-invent the wheels of 20th-century capitalism.

The ultimate intellectual difference between the Experimentalist School and the Convergence School lies in:

- The extent that each school recognises the role of political factors in economic policymaking; and
- The extent to which each school accepts the validity of neo-classical economics in guiding root-and-branch reform of economic systems.

Neglecting the dictates of political logic, the Experimentalist School is inclined towards cautious hesitancy on economic grounds because it believes that:

“Marshallian analysis is best suited to the analysis of incremental or marginal changes in market systems operating under stable institutions ...[and hence the] relevance of standard analytic results to China, where the institutional structure is neither uniform nor stable, is open to question” (Rawski, 1995).

The Convergence School, on the other hand, is heavily inspired by the neo-classical revival in development economics. The revival was built on two observations about the post-World War II period: developing economies with fewer distortions have generally performed better than the economies with more distortions⁸⁶, and radical reversal from extreme dirigisme was usually followed by sustained growth⁸⁷. This difference in faith in neo-classical economics has influenced every debate in economic policy in this century; and, when viewed in this light, it suggests that the debate between the Experimentalist School and the Convergence School is unlikely to result in final agreement soon.

Policy Implications for China

Fortunately, events in China have not waited for the resolution of the debate between the two schools. As documented earlier, China has now intensified the privatisation of small and medium SOEs, and turned a blind eye to the conversion of TVEs into share-holding co-operatives and the removal of red caps by pseudo-TVEs.

One could take the lead of the Experimentalist School and attribute the first trend to the state's ignorance of the significant TFP growth in the SOE sector (Naughton, 1995, pp. 314), and attribute the second trend to the political apathy for market socialism despite its proven viability (Putterman, 1995, pp. 1061). Or, one could take the lead of the Convergence School and interpret the trends as tacit admission by the Chinese government that decentralising reforms cannot overcome the microeconomic inefficiency, macroeconomic instability and social tensions caused by overwhelming state ownership of the capital stock, and that the TVE ownership form is not viable in the face of mushrooming (and, increasingly, larger-scale) private enterprises and in the face of increased labour mobility. While some members of the E-school may not go so far as to view these two recent trends as undesirable, they could regard these developments as unnecessary for better economic and social performance in China (Putterman, 1995, pp. 1064), at least in

the short term. The C-school, in strong contrast, believes that faster privatisation of SOEs and TVEs, and more sweeping industrial and trade deregulation will produce a more efficient growth path and a lower inflation rate.

Regardless of one's verdict on the debate between the two schools, one should be reminded that China will face many deep problems in the coming years. One could enumerate the main economic reform challenges as follows: (1) the reform of the large SOEs; (2) the modernisation of the fiscal system and of federal–local fiscal relationships; (3) the development of a non–state financial sector; (4) the elimination of policies that aggravate regional inequality; and (5) the establishment of market–supporting institutions and commercial law.

Finally, brief comments on these five challenges are set out below.

Ownership Transformation of the Large SOEs

At the 15th Party Congress in 1997, the SOE reform package had two components. The largest 1 000 SOEs were to remain under state ownership, and be nurtured with preferential loans to develop into large conglomerates like the Korean *chaebols*. The rest of the SOE sector would be privatised. Herein again is the much–vaulted dual–track reform strategy, one component for the conservative planners and one component for the liberal reformers.

This retention of large SOEs misses the point that the Korean *chaebols* are privately owned. The international experiences with large SOEs have generally been dismal ones. Large SOEs are usually regarded as too big to be allowed, and the result is that they tend to be a drain on the state budget. Malaysia, for example, started its state–owned *chaebol* programme (e.g. Perwaja) in the late 1980s, and the experience has been a negative one. *A priori*, there is no presumption that bureaucrats can run large SOEs more efficiently than small SOEs. The only certainty is that the failure of a large SOE is more costly than the failure of a small SOE. For this reason, China will continue to face macroeconomic and social instability generated by its SOE sector.

Modernisation of the Fiscal System

The 1994 tax reform has not reversed the decline in revenue as hoped. Tax collection in 1994 was 9.1 per cent of GDP⁸⁸, down from 13.1 per cent in 1993. While the continued financial weakening of the SOE sector was an important reason for the decline, it appeared that many branches of the new National Tax Service had not really divorced themselves from the influence of the local governments, which wanted to retain the funds for local development.

The tax system has continued to be badly administered, hence allowing tax fraud and tax evasion. Under the new VAT system, producers receive VAT refunds on their exports. However, the large amount of false export claims has resulted in over–payment of VAT refunds. The government has suspended the VAT refunds for exports. Local governments are continuing to give illegal tax exemptions, such that the actual customs revenue (which goes to the central government) is only 6 per cent of total import value, despite an average tariff rate of over 30 per cent⁸⁹.

It is imperative that tax administration is improved and that central–local fiscal relations be better institutionalised to yield independent tax authority to the central and local governments. Otherwise, the state would not be able to finance the infrastructure investments required to prevent bottlenecks that would slow economic growth.

Development of the Non–state Financial Sector

Presently, the state banks dwarf all other financial institutions as sources of funds, and SOEs receive about 70 per cent of total domestic credit. Recognising the gross inefficiencies of the state banks, the Chinese government has ordered them to commercialise their operations. To the extent that the state banks would respond to these new exhortations, more capital would be channelled to the more efficient non–state enterprises, a desirable outcome.

Both the transformation of the state banks and the greater access to investment funds by the non–state financial institutions would be achieved faster if the government unleashed competition by legalising non–state financial institutions. The private banks would compete directly against the state banks; and the private non–bank financial institutions, by deepening the equity and bond markets, would create alternative sources of investment funds. Another desirable by–product of the competition from the non–state financial institutions is that it would be more difficult (costly) for the government to impose many non–economic objectives on the state banks.

Given the grave financial crisis that state–managed pension schemes have caused in many developed countries, China should avoid this future financial trap by allowing the establishment of private pension funds. Concretely, the government should not expand the existing state–managed pension schemes to cover non–state employees. The present virtual monopoly status of the People’s Insurance Company of China in providing social insurance to non–state employees is hard to justify.

Elimination of Policies that Aggravate Regional Inequalities

Recently announced plans include giving the backward interior provinces the same preferential trade and investment enjoyed by the coastal provinces, and eliminating some of the special tax benefits enjoyed by the coastal areas. These measures should help to ameliorate the growing regional inequalities of the past decade, though the coastal regions will continue to benefit from an inherent geographical advantage in participating in world trade. It is also important to end price controls on grain prices for farmers, and to provide more support for social infrastructure in the rural areas.

Deepening of Market–supporting Institutions

The rule of law is an absolute necessity for the establishment of a system of property rights, and an independent judiciary body is required for objective adjudication of disputes. Furthermore, regulatory institutions to supervise the financial markets are important in maintaining the integrity of these markets, and hence the public confidence in them. The state should focus on delivering social services that markets usually provide inadequately, if at all e.g. welfare, education (especially in rural areas), and health care to the indigent. The correction of market failures like those above will both improve the working of a market economy and strengthen its political foundations.

NOTES

1. Ratios computed at 1990 prices.
2. Sachs and Woo (1997) proposed this classification. Their dichotomy is similar to the narrative device of Murrell (1995) who coined the term “the Cambridge (Mass.) Group perspective” to describe one coherent viewpoint of the transition from central planning, even though the alleged group members differ considerably among themselves on specific issues.
3. Naughton, (1995, pp. 309). Rawski (1995, pp. 1152) also provided a similar unintended virtuous cycle description of China’s reform process.
4. As China’s ability to grow rapidly reflects its particular economic structure, China’s gradualist strategy is therefore not transferable to Eastern Europe and the former Soviet Union, because of fundamental differences in their economic structures; Sachs and Woo (1994).
5. Since the death of Mao, a party congress (where delegates from party branches throughout the country would gather in Beijing to elect the central committee) has been held every five years since 1977. Important meetings that involve the extended leadership in between party congresses are known as plenums.
6. The late Premier Zhu Enlai enunciated the Four Modernisations in 1976.
7. Needless to say, most of the liberal reformers were economic liberals, not political liberals.
8. Quoted in Zhou (1996) pp. 106.
9. An SOE is a nationally–owned enterprise in the sense that the central government is the ultimate authority for the operations of the enterprise and the disposition of its assets, even though the SOE in most cases has been assigned to the provincial or county government for supervision and management. The non–state enterprises are those enterprises in which the central government lacks final authority over the disposition of assets. The non–state sector consists of community–owned (collectively owned) enterprises (COEs), co–operatives, individual–owned enterprises, private corporations, and foreign joint ventures. COEs are owned by all the residents of the city or township or village, and co–operatives by a small group of persons.
10. Strictly speaking, the 1984 reclassification of industrial activities within agricultural production units from “agriculture” to “industry” renders comparison prior to that year invalid. The COE share of gross industrial output went from 30 per cent in 1984 to 38 per cent in 1993, and the share of private corporations, individual–enterprises and joint ventures from 1 per cent to 19 per cent.
11. Constructed from Colin Mackerras and Amanda Yorke (1991), and Richard Baum 1994.
12. Jiang Jing was not included in the list contained in Mackerras and Yorke (1991), but was a member according to Evans (1997, pp. 197).
13. The book was compiled in 1962 for the use of the People’s Liberation Army.
14. Apparently, Deng Xiaoping sided with Mao on this issue against Zhou Enlai and Chen Yun; Evans (1997, pp. 149).
15. This explicit reference in the party’s constitution to the guiding role of Mao’s thoughts was deleted at the 8th Party Congress in 1956; Evans (1997, pp. 91 and 133). The deletion was partly the desire of Mao’s colleagues to prevent a personality cult, and partly the recognition that victory had obviated the need for the party to have a single focal point.

16. The humiliation of China by foreigners started with its defeat in the First Opium War of 1839-1842 when Britain forced China to legalise the importing and internal distribution of opium. This defeat marked the start of steady loss of Chinese territory, and of a steady flow of extraordinary legal concessions to foreigners living in China. Russia grabbed the northernmost parts of Manchuria, Japan grabbed the remaining parts of Manchuria, the Germans grabbed Shandong, Britain grabbed Hong Kong, and Portugal grabbed Macao. Shanghai and Tianjin were made international cities under the administration of several European powers. Europeans, Americans, and Japanese were not subject to Chinese laws while on Chinese soil. The collection of Chinese customs revenue was put under the supervision of foreigners.
17. Mao's conclusion of "revisionism" in the Soviet Union was not unique. Milovan Djilas, former vice-president of Yugoslavia, wrote a book entitled *The New Class: An Analysis of the Communist System* in 1957.
18. Later, Khrushchev criticised Mao's programmes of agricultural collectivisation and crash industrialisation as left deviations and dangerous fanaticism, and in 1960 stopped Soviet aid to China.
19. Becker (1996).
20. Salisbury (1992), Chapter 19.
21. Deng Xiaoping did not attend the first half Lushan conference where Peng was first denounced because of a broken leg.
22. Later, possibly as an act of implicit penitence for the great suffering he had wrought, Mao went on to a vegetarian diet for the duration of the famine.
23. Official Chinese accounts of that time blamed the food shortages on droughts and on the malicious withdrawal of Soviet aid.
24. This description applies to communes with three levels of organisation. In some areas, there were four levels of organisation: the commune, the large brigade, the small brigade, and the production team. In the 4-level case, the large brigade corresponded to the production brigade of the 3-level case; and the small brigade corresponded to the production team of the 3-level case. The production team in the 4-level case averaged six peasant households. Information from Eckstein (1977, Chapter 3).
25. Quoted in Evans (1997, pp. 163-167).
26. In 1965, Lin Biao had embraced the extreme egalitarianism enunciated by Mao by removing all identifications of rank on army uniform.
27. Chen Yun had a superior understanding of Mao's wrath. He had removed himself from office in 1962 on medical grounds after Mao commented on an internal memorandum that:
"This man, Chen Yun, came from a small businessman's background. He cannot get rid of his bourgeois character. He leans consistently to the right". (Li, 1994, pp. 392)
28. Conflicting accounts have appeared about the demise of Lin Biao, some of which are disinformation by the Taipei Chinese. One remaining mystifying aspect is that the Mongolians have claimed that Lin Biao was not among the bodies identified.
29. Figures from Zheng (1997, pp. 138).
30. Mao the strategist created a role for himself as the indispensable arbiter in international politics as well as in domestic disputes by receiving Richard Nixon in 1972.
31. In a letter to Hua in October 1976, Deng had pledged his loyalty to Hua and that he would not seek to reverse the negative verdict that the party had passed on him in 1976 — *yong bu fan an*.
32. The post of general secretary that Deng held before the Cultural Revolution ended in 1969 when the Central Party Secretariat was abolished. (Baum, 1994, pp. 409)
33. The short-lived *zerentian* system of 1962 was a milder version of *baochan daohu* because the crucial farming decisions remained at the brigade/team level, and "only field management was left to individual households." (Zhou, 1996, pp. 50)

34. Zhou (1996) Chapter 3.
35. This was largely because of the strong opposition of Marshal Ye Jianying to Hua's removal.
36. Quoted in MacFarquhar, (1997), who concluded that Mao Zedong was closer to Hitler than to Stalin in personality, and in achievements.
37. Some authors (e.g. Harding, 1987) use the terms moderate reformers and radical reformers to denote the Maoist–Stalinist camp and the market–oriented camp respectively. For the purpose of this paper, radical reformers would be those who push for complete convergence to a capitalist market economy, which is in line with the terms applied to Eastern European reformers after 1989.
38. See Fewsmith (1994, pp. 47-48) for Chen Yun's concerns that the household responsibility system was undermining the central plan, and the state's ability to extract resources from the rural areas.
39. Chen Yun (1983) was a modified Marxist in that he thought that traditional Stalinist central planning discriminated too much against light industry in favour of heavy industry, and that traditional Stalinist central planning paid too little attention to agricultural development.
40. In an interview with the Italian journalist Oriana Fallici in 1980, Deng said that "for a leader to pick his own successor is a feudal practice." (Baum, 1994, pp. 93)
41. Baum (1994, pp. 178).
42. The phrase first appeared in *Guangming Ribao*, 11 May 1978.
43. Yan (1995, pp. 7).
44. Quoted in Chen (1995, pp. 148). Su Shaozhi, the director of the Marxist–Leninist Institute, proclaimed at the end of 1984 that: "There are no Marxist quotations for what we are doing now." (Baum, 1994, pp. 178).
45. Although Oskar Lange (1936) did not explicitly consider the treatment of international trade under market socialism, the logical extension of his free market approach would mean support for free trade. So the Chinese Langeans followed Stalin when it came to international trade.
46. In fact, one important factor behind Mao's rehabilitation of Deng in July 1973 was his desire to balance the strong military presence with an experienced, powerful leader of the party and state bureaucracies (and who was also a respected military commander), and to have him implement the delicate task of reining in the army. One of Deng's first acts upon rehabilitation was to change the commanders in eight of the eleven regions. Shortly after that, Deng was appointed the chief of staff of the armed forces.
47. For example, "General, you should not behave this way (*Jiangjun, ni buneng zheyangzuo*) and "What if I were genuine? (*Jiaguo wo shi zhende?*)" which were, respectively, a sarcastic poem on the avariciousness of an elderly general, and a satirical play on the chicaneries of a young man pretending to be the son of a revolutionary hero.
48. Evans (1997) pp. 197.
49. China was Pol Pot's chief foreigner support because Vietnam was regarded to be an ally of the Soviet Union.
50. Income tax from SOEs was 19 per cent of GNP in 1978, 10 per cent in 1984, and 4 per cent in 1988, showing that drop in SOE profitability was the main cause of the decline in total state revenue. Data from table 7.3 of the World Bank (1995).
51. Li (1986c).
52. Baum (1994) pp. 203.
53. Baum (1994) pp. 202.
54. According to Pye (1997) pp. 210: "the idea of articulating any special interest was contrary to the Confucian tradition, which held that the supreme value was selflessness and the ultimate ideal was a willingness to engage in self–sacrifice for the good of the collectivity. The Chinese, of course, acted in terms of their individual interests, but individualism was not an ideal and, therefore, they could not openly articulate their interests".

55. Yan (1995) pp. 7.
56. Baum (1994), pp. 198. Earlier, Hu Qili, leading member of Hu Yaobang's group and member of the Central Committee, declared in his May Day speech that "China's intellectuals should have the courage to 'break through' Marxist concepts which 'experience had already proved to be outmoded or not entirely correct' and called for more democracy and reinforcement of the rule of law." (Evans, 1997, pp. 278)
57. Baum (1994), pp. 221.
58. CFELG was established in 1954 with Chen Yun as its first head. CFELG was suspended during the Cultural Revolution, and Chen Yun revived it when he returned to the centre stage in 1979 as the chief economic manager. See Lieberthal and Oksenberg (1988) and Wang and Fewsmith (1995) for details on party and state organisations.
59. Mackerras and Yorke (1991), pp. 50.
60. Fewsmith (1994), pp. 214-215.
61. See Cheng (1995, pp. 192) a detailed insider account of the debate on the 1988 price reform.
62. A more colourful phrase from Deng is found in Fewsmith (1994, pp. 223): "We are not afraid of stormy waves but will pass all the hurdles braving the wind and the waves."
63. Evans (1997) pp. 287.
64. The terms in Chinese are *guojia dui* and *difang dui*, respectively; Fewsmith (1994) pp. 246. The "feudal lord economy" was also called "independent kingdom" (*duli wangguo*); Baum (1996) pp. 326.
65. Statement by Chen Yun in November 1991; Baum (1994), pp. 337.
66. As pointed out earlier, Deng believed in a dynamic Marxism that changed with material circumstances, and he, also being a confident man, was not particularly concerned about the possibility of "the chickens coming home to roost."
67. Baum (1994), pp. 295-296.
68. Quoted in Evans (1997), pp. 307.
69. The main remaining die-hard central planner in May 1998 is Deng Liqun who wrote a harsh critique (the so-called ten thousand character book, *wanzishu*) of Jiang Zemin's use of the shareholding mechanism to reform the state sector that was generally ignored.
70. For example, McMillan and Naughton (1992) and Rawski (1994).
71. For example, Nolan (1993) and Rawski (1995) are optimistic about the economic viability of TVEs because they reject the standard property rights analysis that concludes that private firms are more efficient than public firms are.
72. "*Guo you qiye sheng hua gaige ke burong huan*," (No time shall be lost in further reforming state owned enterprises), speech at the 4th meeting of the 8th People's Congress, *People's Daily, Overseas Edition*, 11 March 1996.
73. See debate in Jefferson, Rawski, and Zheng (1992, 1994, 1996), Woo, Hai, Jin and Fan (1994), Woo, Fan, Hai and Jin (1993 and 1994), and Woo (1998).
74. See Fan and Woo (1996).
75. "State asset drain must end," *China Daily*, 13 December 1995. See also "State toughens stand to protect its possessions," *China Daily*, 2 June 1995; "Asset checks can stop fiddles" *China Daily*, 7 June 1995; and "Market investigated for losing State assets," *China Daily*, 2 June 1995.
76. "Decision of the CPC Central Committee on issues concerning the establishment of a socialist market economic structure," *China Daily*, Supplement, 17 November 1993.

77. *Xiang-ban*, *cun-ban*, and *lian-ban* are classified as “collective-owned enterprises” (*jit*). Of total TVE output in 1991, *xiang-ban* accounted for 37 per cent, *cun-ban* for 30 per cent, *lian-ban* for 6 per cent, and *geti* for 27 per cent. Output from industrial TVEs accounted for 75 per cent of total TVE output in 1991. Of total industrial TVE output, *xiang-ban* accounted for 41 per cent, *cun-ban* for 34 per cent, *lian-ban* for 6 per cent, and *geti* for 19 per cent. Data are from *1992 TVE Yearbook*.
78. This implicit narrow definition explains why Naughton (1994) and Walder (1995) categorically described TVEs as “local government-owned.”
79. According to Oi, the county government was corporate headquarters, the township governments were regional headquarters, and the villages were companies.
80. Che and Qian (1996) and Li (1996) attribute the mushrooming of TVEs despite their insecure (unambiguous) property rights to the need to buy protection and co-operation from the local governments. TVEs are created by the lack of commitment by the state to fully accept and protect private property and private contracts, and to provide the institutions that will promote the growth of private businesses.
81. A paraphrase of Clinton’s guiding principle (“It’s the economy, stupid”) in his successful 1992 presidential campaign that focussed relentlessly on economic issues.
82. Dong (1979).
83. And, of course, when Zhao Ziyang was involved in an accident (partly caused by Deng’s order to speed up on deregulating prices when the economy was overheated), he was shoved aside to be replaced by Jiang Zemin.
84. Huang (1996), pp. 2.
85. The author’s comparison of the two schools has ignored the problem of multiple equilibria. The E-school can only hope that the market equilibrium closest to the central planning point is always a high-efficiency equilibrium. To the extent that high-efficiency equilibria are those with many deep markets, the avoidance of a low-efficiency equilibrium requires a minimum critical effort in the reform programme. For example, an efficient stock market requires depth, and this can be achieved by mass privatisation of a significant portion of the SOE sector.
86. Balassa (1982), Krueger (1978), and Little, Scott and Scitovsky (1970).
87. For example, Indonesia in 1966, and Bolivia in 1985; see Woo, Glassburner and Nasution (1994) and Sachs (1987) respectively.
88. Wall Street Journal, “Tax Man Misses Out on China’s Prosperity,” 26 July 1995.
89. This low realised tariff rate also reflects the immense amount of export-processing activities where the import of the raw inputs for the assembly operations entered tariff-free.

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