3. Reflections on 40 years of China's reforms

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In December 2018, it will be 40 years since Deng Xiaoping kicked off China's reforms with his famous speech calling on citizens to 'Emancipate the mind, seek the truth from facts and unite as one in looking to the future', which concluded the 1978 Central Economic Work Conference and set the stage for the third plenum of the eleventh Central Committee of the Communist Party of China (CPC). The speech brilliantly used Mao Zedong's own thoughts to depart from Maoism, rejected the 'two whatevers' of Mao's successor, Hua Guofeng ('Whatever Mao said, whatever Mao did'), and triggered decades of reforms that would bring China to where it is now—the second-largest economy in the world and one of the few that will soon[2] have made the journey from low-income to high-income country.

This fortieth anniversary is a good time to reflect on China's reforms. Understanding China's reforms is important first and foremost for getting the historical record right, and this record is still shifting despite the many volumes that have already been devoted to the topic. Understanding China's past reforms and, with them, the basis for China's success is also important for China's future reforms; understanding the path travelled, the circumstances under which historical decisions were made and what their effects were on the course of China's economy will inform decision-makers on where to go next. Third, reflections on China's reforms are increasingly important for the rest of the world. Because of China's economic success, more and more countries see China as an example to emulate, a model of development that could help them move from rags to riches within a generation.

With the nineteenth National Congress of the CPC last October, for the first time, as far as I know, China now also sees itself as such an example. One excerpt from General Secretary Xi Jinping's speech in particular signifies a departure from China's past ambitions and aspirations. In discussing the success of China, and by implication the Communist Party, Xi stated:

> It means that the path, the theory, the system, and the culture of socialism with Chinese characteristics have kept developing, blazing a new trail for other developing countries to achieve modernization. It offers a new option for other countries and

1 This chapter reflects the personal opinions of the author and should in no way be attributed to the World Bank, its executive board or its member countries. An earlier version of this chapter was presented at Fudan University.

2 By about 2024, in our estimates, or even sooner, if the renminbi appreciates more rapidly in real terms than anticipated.

> nations who want to speed up their development while preserving their independence; and it offers Chinese wisdom and a Chinese approach to solving the problems facing mankind. (Xi 2017)

In some ways, China's reforms followed many of the prescriptions mainstream economists would recommend (Figure 3.1). The country opened up for trade and foreign investment, gradually liberalised prices, diversified ownership, strengthened property rights and kept inflation under control. Continued (relative) macroeconomic stability allowed high savings to be turned into high investment and rapid urbanisation, which in turn triggered rapid structural transformation and productivity growth. But this simplifies and obfuscates the essence of China's reforms: it was the unique way in which China went about reforming its system that makes the country's reform experience of interest.

China's gradual, experimental method of reform of its economic system, especially in the early days, was in sharp contrast with the reforms in Eastern Europe and the former Soviet Union. Although they were often compared, China and other transitional countries were simply too different in terms of their initial economic conditions, political development and external environment to make comparison of much use. Similarly, comparison with much of the Latin American reforms seems out of place; the likes of Brazil, Mexico and Argentina were far closer to a market-based system than China in 1978, and their reforms—liberalisation and macroeconomic stability—were of a different order of complexity to China's. The policy prescription for Latin America was therefore focused on these issues, and the 'Washington consensus', which summarised the policy prescription for those countries, was never meant to be a growth or development model. Contrasting China's development approach with that of the Washington consensus therefore makes little sense.

At the onset of reforms, China was among the poorest nations on earth and a predominantly rural, agricultural country. China had barely 25 years of history of central planning, which had been marred by the failure of the Great Leap Forward and the political disruptions during the Cultural Revolution. The country was neither integrated into the world economy nor a member of the Council for Mutual Economic Assistance (Comecon). Internally—in part due to Mao's 'Third Front', which required individual regions to be able to survive economic isolation in case of a war—industry was inefficient, but also far less concentrated than in Eastern Europe and the former Soviet Union. When central planning was relaxed, competition among regions and their enterprises became possible, and economic oligarchy was avoided. Gradual reforms meant that the physical and human capital built under socialism did not become obsolete as a consequence of a transition shock. Perhaps most importantly, although major political reforms of the party and state were implemented over time, the state and the ruling party remained intact throughout, so China could focus on its economic and social transitions.

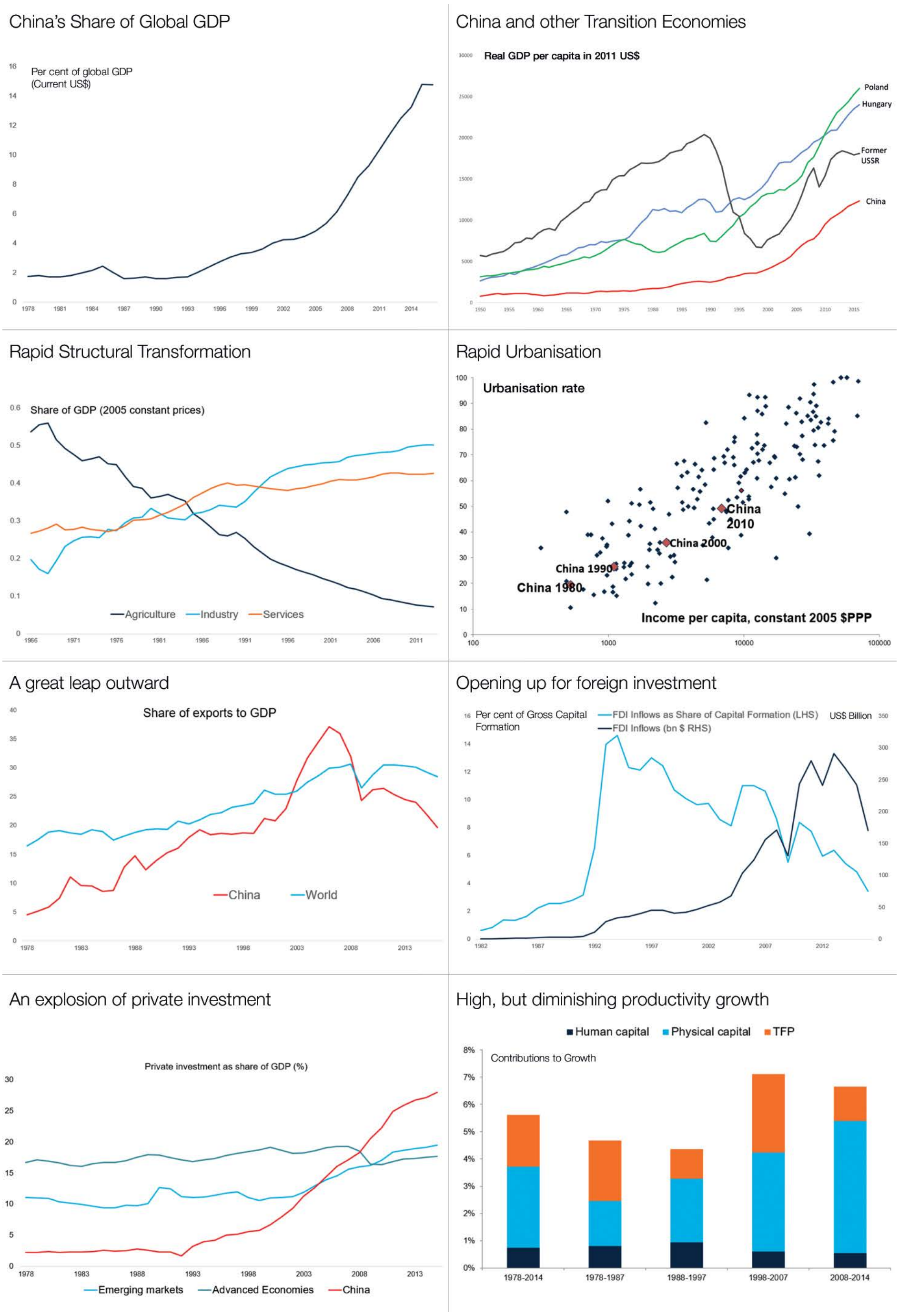

Figure 3.1 China's economic development, 1978–2016

Sources: World Bank (2018); Bolt et al. (2018).

In contrast, most other transitional countries were middle-income, highly urbanised and industrialised and had experienced more than 40 years and sometimes 70 years of collectivisation and state planning. They were highly specialised in production structure and integrated into the Comecon, with heavy concentration of industry in often monopolistic enterprises. The gradual reforms initiated in the system—first in Hungary and later in the Soviet Union—had met with only limited success, especially in the latter. Reforms started under conditions of large macroeconomic imbalances and a large monetary overhang, so price liberalisation led to an almost immediate and disruptive jump in inflation, which eroded people's savings.

The biggest difference with China was undoubtedly the collapse of political systems throughout much of the former Soviet Union and Eastern Europe. This collapse made a gradual transition of the economic system virtually impossible for most. For some, notably countries in Eastern Europe, a new institutional framework was swiftly found in the form of the European Union, to which most have now acceded. This adoption of a ready-made economic system eliminated the need for a search for institutions that would fit the individual country. Though perhaps less than fully suited for the middle-income transitional countries, the EU framework offered stability and a clearly specified reform path. As a result, the transitional recession for those that aspired to accede to the European Union was short, and most are now thriving high-income countries.

How did China reform?

Gradual reforms

Reforms in China developed only gradually, starting in rural areas with the household responsibility system and township and village enterprises (TVEs) and some initial steps to open up the economy to foreign trade and investment, which only started to play a significant role in the 1990s (Table 3.1). Gradual also were the moves on the financial sector and state-owned enterprise (SOE) reform, which were much discussed throughout the 1980s, but gained momentum only in the mid-1990s. 'Crossing the river by feeling the stones' became China's mode of economic reform, implementing partial reforms in an experimental manner, often starting in a few regions and expanding them on proven success. Only with the 1993 'Decisions of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economic Structure' did a broader overall strategy emerge. Yet, this, too, was implemented gradually and experimentally rather than comprehensively.

Table 3.1 Major reform steps in China, 1978–2017

Year	Reform step
1978	Deng Xiaoping's speech at the Central Party Work Conference, 'Emancipate the mind, seek the truth from facts and unite as one in looking to the future'
1978	Communiqué of the third Central Committee of the CPC, eleventh National Congress of the CPC, confirming 'four modernisations' as the major goal for reforms
1979	'Open door' policy initiated; foreign trade and investment reforms begin; law on joint venture companies passed
1979	Limited official encouragement of the household responsibility system informally initiated in 1976
1979	Three specialised banks separated from the People's Bank (the central bank)
1980	First four special economic zones created
1980	'Eating from separate kitchens' reforms in intergovernmental fiscal relations
1984	Socialist commodity economy endorsed at the third plenum of the twelfth National Congress of the CPC
1984	Individual enterprises with fewer than eight employees officially allowed
1984	Tax-for-profit reforms for SOEs
1986	Provisional bankruptcy law passed for SOEs
1986	CPC approves comprehensive 'Economic System Reform Implementation Plan'
1987	Contract responsibility system introduced to SOEs
1989	Retrenchment policy; halt on reforms
1990	Stock exchanges open in Shenzhen and Shanghai
1992	Deng Xiaoping's 'tour through the south' reignites reforms
1993	16-point program introduced to fight inflation
1993	Decision of the third plenum of the fourteenth National Congress of the CPC to establish a 'socialist market economy', paving the way for fiscal, financial and SOE reforms
1994	Renminbi convertible for current account transactions announced
1994	Tax-sharing system reforms introduced
1994	Policy banks established; commercialisation of banking system announced
1995	Central Bank Law, Banking Law and Budget Law enacted
1995	Fifth plenum of the thirteenth National Congress of the CPC confirms SOE reform plans to 'grasp the big, let go of the small'
1996	China in compliance with International Monetary Fund Article VIII (current account convertibility)
1999	Urban housing reforms initiated; almost all housing stock privatised
1999	Government reforms consolidate industry-related ministries and institutes
2001	China accedes to World Trade Organization
2001	Tenth five-year plan emphasises efficiency, structural change and industrial upgrading
2003	State Commission for the Restructuring of the Economic System merged with the State Planning Commission to create the National Development and Reform Commission (NDRC)
2003	Third plenum of the sixteenth National Congress of the CPC decision to 'perfect' the socialist market economy
2004	Chinese constitution amended to guarantee private property rights

Year	Reform step
2005	Construction Bank and Bank of China initial public offerings
2006	Sixth plenum of the sixteenth National Congress of the CPC establishes the goal of creating a 'harmonious society'
2006	Medium-term plan for science and technology approved
2008	Stimulus program launched in reaction to the bankruptcy of Lehman Brothers and the Global Financial Crisis (GFC)
2013	Twelfth five-year plan launched, emphasising rebalancing and avoiding the middle-income trap
2014	Third plenum of the eighteenth National Congress of the CPC decides on 'Decisive Role of the Market in Resource Allocation, Adherence to the Basis Economic System (Dominance of SOEs)'
2015	Fourth plenum of the eighteenth National Congress of the CPC decides on rule of law with Chinese characteristics
2016	Thirteenth five-year plan launched, emphasising innovation and productivity as drivers of growth
2017	Nineteenth National Congress of the CPC defines 'new era' and China's long-term goals for socialist modernisation

Sources: Hofman and Wu (2009); Gewirtz (2017); Bottelier (2018); Government of China official documents and publications.

There were several reasons for this gradual approach. First, gradualism was a means to circumvent political resistance to reform (Wu 2005). While the Cultural Revolution's political ideology of class struggle had been put to rest after Mao's death, many in the Communist Party retained a deep suspicion of the market and instead trusted the 'administrative' system (including the party) more. Gewirtz (2017) provides a lively account of these ideological battles in the early days of reform and how foreign advisors (including from the World Bank) played a role in this. Second, gradual, experimental reform was a pragmatic approach in a heavily distorted environment in which 'first best' solutions were unlikely to apply. Experimental reforms, confined to specific regions or sectors, allowed the authorities to gather information on the effects of reforms that could not be anticipated. They were also necessary to develop and test the administrative procedures and complementary policies needed to implement the reforms. With proven success, the experiment could be expanded to other regions and sectors. Third, experimental reform may have suited the Chinese culture well as a means to avoid loss of face; if something did not work, it could be abandoned as an experiment, rather than considered a policy failure. China's gradual strategy reinforced the credibility of reform over time. By undertaking reforms one step at a time, and starting with those most likely to deliver results, the government built up its reputation for delivering on reform. With every successful reform, the likelihood that the next one would also be a success undoubtedly increased. It also gradually built up the experience and skills for the design and implementation of reforms. Thus, by gradually reforming, China built up its 'reform' capital.

Decentralisation and incentives

Decentralisation to local government became a powerful tool for progress within the confines of central political guidance. Provincial and local governments received increasing authority over investment approvals and fiscal resources and policies. Provinces, municipalities and counties were allowed, and even encouraged, to experiment with reforms in specific areas, and successful experiments then became official policy and were quickly adopted throughout the country. In a way, by decentralising, China turned the country into a laboratory for reforms. The fiscal system and the political organisation within the CPC were key in aligning subnational government incentives with those of the centre. The fiscal reforms introduced in 1980, which became known as 'eating from separate kitchens', formed a de facto tax contracting system, with high revenue retention rates for local governments—in particular, for those that were set for growth. For instance, Guangdong province only had to pay a lump sum in revenues to the central government and could retain 100 per cent of the rest. This distributed the benefits of reforms to a large part of the population as well as to local government and party officials, who therefore had strong incentives to pursue growth and promote a market economy (Qian and Weingast 1997). Competition among local governments also served as an effective check on government power, even in the absence of formal controls of such powers.

Within the Communist Party, the personnel promotion system was based largely on achieving growth. The dominant criteria for promotion were growth itself, creation of employment, attraction of foreign direct investment (FDI), control of social unrest and achievement of birth control targets. Four of these five were closely aligned with GDP growth. Experience in the regions also counted heavily in the promotion to higher-level party posts, which provided the most talented with the incentives to gain that experience and to demonstrate their capacity to reform and spur growth. The entrepreneurial role of local government officials also compensated for the lack of the formal institutions of a market economy and ensured the alignment of investors' and local officials' interests. Taken together, this environment provided a strong incentive for growth. A disadvantage was imperfect macroeconomic control and repeated bouts of inflation driven by local government loosening of investment and credit controls. Further, these conditions gave rise to local protectionism, which threatened to undermine China's unified market and competition among domestic firms. It also encouraged corruption among officials as the dividing line between official roles and private interests became increasingly vague. While in the first decades of reforms corruption was controlled by harsh punishment, in the decade leading up to Xi Jinping's anticorruption campaign, corruption became a major political and economic challenge.

Pragmatism and transitional institutions

China's approach to reform provided room for the country's own particular institutions to emerge, which suited the country's purposes well at any given point on its reform path. The 'dual track' system for growing out of the planned economy was preeminent among all transitional institutions. It allowed a continuation of the planning system at planned prices, which avoided a collapse in production, but at the margin, the system allowed an unplanned economy to emerge. This also provided the information needed to gradually reform planned prices in such a way that, by the time of the abolition of most material planning in the mid-1990s, prices within and outside the plan had been largely aligned. Similarly, the de facto fiscal contracting system installed after 1980 gave subnational governments strong incentives for growth by leaving much of the incremental revenue in the provinces. Local officials' growing control over resources provided them with the incentives to pursue reforms and attract the investments needed to promote growth. The price, however, was a growing loss of macroeconomic control and, when inflation became the dominant concern in the early 1990s, the system was replaced with a more mainstream tax-sharing system, although not without a considerable political struggle led by then vice-premier Zhu Rongji.

Perhaps the most successful example of a transitional institution was the TVE—an enterprise form that operated outside the plan, but was owned and to some extent managed by local governments across rural China. Born out of the collective production brigades, these enterprises were highly successful in expanding production and creating employment, even though their ownership form was far from the private ownership that standard theory predicted would work best. However, as argued by Qian and Wu (2005), in an environment where private property was in many circles frowned on and barely protected by law, creating an ownership form that aligned the interests of local government with those of the enterprise was crucial for its development and survival. Although perhaps not the most efficient ownership form imaginable, it was a feasible one—one that was more efficient than the prevailing SOEs—and as such it increased the efficiency of the economy as a whole. As protection of property rights improved, the success of the TVEs started to falter and, in the past two decades, they have been overtaken by private and foreign-invested companies as the main source of growth and job creation.

China used its distinctive land policies to accelerate the country's development. Since the 1950s, land has been owned by the state in urban areas and by collectives in rural areas. Decentralising user rights to households in rural areas triggered sharp productivity increases in agriculture, which made rapid industrialisation possible. In urban areas, land value increases and conversion of rural to urban land played an important role in financing rapid urbanisation and infrastructure construction. By the early 1990s, lack of infrastructure had become a bottleneck for growth. Starting in large cities, urban development and infrastructure companies (UDICs) became part of the solution. Often capitalised by land user rights from local governments, UDICs were able to borrow funds to develop the infrastructure needed to expand cities for industrial and residential use. The increase in value of the land thus unlocked accrued to the UDICs, and they could use it to pay off their debt. UDICs were a practical means to allow local governments to borrow—something that had been banned in the 1995 Budget Law. By the second decade of this century, this mechanism of land-based finance had run out of steam and the disadvantages of the system started to outweigh the advantages. Local governments' overreliance on land revenue had led to excessive land conversion, inefficient city design, debt accumulation and social unrest among those communities whose land had been expropriated. Thus, the 2014 revision of the Budget Law opened up formal channels for local government borrowing, while gradually closing the off–balance sheet route.

Institutionalisation of reforms

The study and formulation of reforms and new policies—which is of importance to other countries that aspire to reform—was itself institutionalised in China. Starting with the China Academy of Social Sciences in the early days of reform—the only place in which the study of 'Western' economics had continued throughout the Cultural Revolution—a variety of think tanks sprang up to study and promote reform. Among the most influential was the Development Research Center (DRC) of the State Council, a policy research organisation directly under the Cabinet, which provided a continuing stream of inputs for reforms. In recent years, the DRC has been a partner of the World Bank, among others, in the *China 2030* (2013) and *Urban China* (2014) studies. Today, the Center for Knowledge for International Development under the DRC, founded in 2017, is tasked with studying China's reform experience to make it accessible and digestible for other countries. Another highly influential body was the Systems Reform Commission (SRC) (formally, the State Commission for the Reform of the Economic System), whose task was to propose reforms in the system. The DRC and SRC, while government organisations, were set up to provide China's leadership with options for reforms in the economic system and in economic policy. Not burdened by institutional interests like many traditional government departments, these organisations became the source of many of the reforms undertaken in the 1980s and 1990s.

Where next?

It is helpful to analytically distinguish three phases of reforms: market-*seeking* reforms, roughly from 1978 to 1993; market-*building* reforms, from 1993 to about 2003; and market-*enhancing* reforms, from about 2003 onwards (Figure 3.2). This division is to some extent arbitrary, and the timing of the phases is not exact. Nevertheless, such a division captures the distinct policy directions taken in each of the phases.

In the first phase, there was a genuine search for the right economic institutions for China. As argued above, in part driven by politics, experimentation and decentralised initiatives, China was searching for ways to allow more of the market into its system. Informed by reforms in Eastern Europe under communism, China's reforms concentrated largely on microeconomics, to some extent with a neglect of macroeconomics—and the highly volatile growth rate in the 1980s bears witness to that. After the retrenchment policy, Deng Xiaoping's tour through southern China made it clear that market reforms were there to stay.

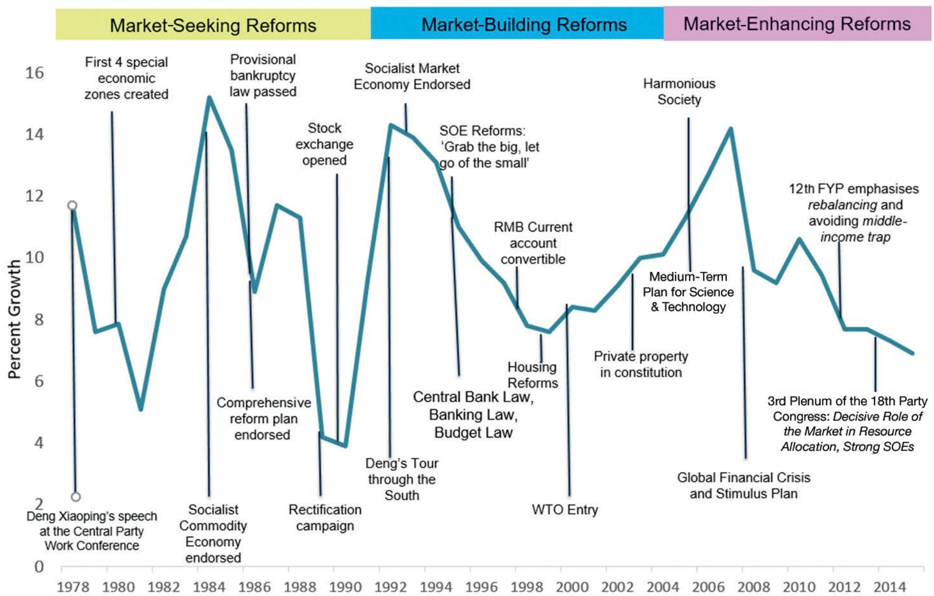

Figure 3.2 Phases of reform

Sources: Wind Database; Hofman and Wu (2009); Gewirtz (2017); Bottelier (2018); various official documents and publications of the Chinese Government.

The decisions of the third plenum of the fourteenth National Congress of the CPC in 1993 triggered the second phase by laying out a comprehensive plan to build the institutions for a market-driven economy, including a modern tax system, enterprise reforms and a financial system that separated policy banks from commercial banking. The start of serious SOE reforms in the mid-1990s allowed those commercial banks to become commercial, the credit plan was abolished in 1995 and housing and (urban) social security reforms followed. Entry to the World Trade Organization (WTO) in 2001 not only served as a lever for domestic reforms, but also ensured much greater competition on the goods market. The slashing of import tariffs made China far more competitive in exports, as well as a viable platform for final assembly of much of the Asia-based exports hitherto produced elsewhere. The unification of the exchange rate at highly competitive levels in 1995 helped boost China's 'great leap outward' and its emergence as a major exporting power.

The inclusion of private property rights in the Chinese constitution in 2004 concluded the market-building phase. This phase—the Zhu Rongji years, if you will—can be seen as one in which the state retreated and left increasing room for the market. Perhaps the best indicator of this was the explosion of private investment, which increased its share in the economy from less than 2 per cent in 1992 to some 15 per cent by 2003 (although some of this was due to a reclassification of collective enterprises as private). The share of private enterprises in industrial production rose from less than one-third in 1995 to 72 per cent in 2003 (Hofman and Wu 2009: Table 2; Lardy 2014: Ch. 3). In 1999, the Chinese Government also consolidated all industry-related ministries into the Ministry of Commerce and the Ministry of Industry and Information Technology.

Since then, reforms have focused on *enhancing* the market. The first of the two main ingredients of this is a gradual expansion of the social safety net (pensions, health care, welfare)—notably, after the 'harmonious society' became the goal of state policy in 2006. Second, we have seen a return of industrial policy, as noted by Ling and Naughton (2016). As these authors argued, 'techno-industrial policy' never left, but had been on the defensive after 1978, only to reemerge after Zhu Rongji left office. Perhaps to signify a new phase, the SRC, which played a key role in the reforms shifting from plan to market, was merged with the State Development Planning Commission in 2003 to form the National Development and Reform Commission (NDRC).

With the publication of the 'Medium-Term Plan for Science and Technology' and initiation of the '16 megaprojects' (both in 2006), industrial policy has returned to the forefront of the government's agenda. This has since been amplified with the fifth plenum of the fourteenth National Congress (on productivity and innovation), the thirteenth five-year plan and the 'Made in China 2025' strategy (in 2015). This return to prominence for industrial policy was supercharged by the GFC, which China countered with a large domestic stimulus, and which provided ample resources for central and local governments to pursue those policies. State banks and SOEs were called on to serve as instruments to implement this policy. Although the third plenum of the eighteenth National Congress in 2014 declared the market should play a 'decisive role' in the allocation of production factors, it also pledged adherence to the 'basic economic system', with public ownership playing a dominant role in the economy.

The new era

The nineteenth National Congress and President Xi's report confirm these policy directions: market-based allocation, a dominant role for public ownership and a strong emphasis on industrial policy and science and technology to achieve the goals of the 'first phase of the new era' (2020–35)—namely, socialist modernisation.

Interestingly, socialist modernisation was also what Deng Xiaoping envisioned when he set out on his reform program in 1978. Deng spoke of the 'four modernisations' of industry, agriculture, national defence and science and technology, the idea of which went back to Zhou Enlai, who first formulated this concept in the 1950s; it became policy in 1963, but was disrupted by the Cultural Revolution.

With 'socialism with Chinese characteristics for the new era', China seems to have found its own distinctive economic system, with markets and state ownership existing side by side and with industrial policy guiding the market. No doubt, the GFC contributed to the idea that a Western-style market economy was not the panacea for China's economic development, and that China had to develop its own economic system. China's current economic system has its own complexities and issues—both internal to China and in the international arena.

Domestically, there is tension between the central government's vision and industrial policies and their decentralised implementation. Once an engine of growth and institutional innovation, decentralised policy implementation has increasingly led to waste and overcapacity, as local governments pursue their own industrial policies and support their own enterprises at the expense of others—foreign and domestic alike. The government reorganisation announced at the 2018 National Congress promises increased central control over government policies and more limited space for local governments to pursue their own course, and is an attempt to resolve this tension. Changes in competition and budget policies further limit this space, while the government's anticorruption policies have reduced incentives for local officials to pursue their traditional entrepreneurial role. At the same time, the government's 'mass entrepreneurship' policies shift that entrepreneurial role further to the market—with a stronger role for the CPC in private enterprises to balance this.

Internationally, China's mixed system encounters increasing resistance. Aside from geopolitical considerations, recent trade tensions reflect the unease of many Organisation for Economic Co-operation and Development (OECD) countries with China's model. They see China's state-led and state-supported enterprises as unfair competition for their enterprises in trade and investment. Aside from trade measures, these countries increasingly call for reciprocity in investment restrictions, and are enhancing their restrictions on acquisition by foreign interests of enterprises with key technologies. These measures could undermine the international system that has much benefited China in the past, and which China's leaders have strongly supported in recent years against a rising tide of protectionism.

It is too early to tell how well 'socialism with Chinese characteristics for the new era' will serve China in achieving its two centennial goals, how the balance between the state and the market will shape up in the years to come and how China's industrial policies will remain compatible with the existing international economic system.

Irrespective of the outcomes, those who believed that by 'crossing the river' China would reach a familiar bank on the other side—a market economy not that different from the many varieties found in OECD countries—need to think again.

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