

# **Asian Giants**

## **China**

### **(ECHI2109 and ECHI2119)**

#### **Some lecture notes on the theory of second best and the evolution of property rights in recent Chinese economic history.**

#### **The Theory of Second Best and China's relative economic success post 1978.**

Despite the various gradual stages in the reform of the Chinese economy up until the early 1990s, there were a number of major distortions (such as a lack of a clear set of private property rights and a relatively under-developed financial sector) left in the economy in the early 1990s. Nevertheless, as indicated earlier, China experienced a relatively rapid rate growth of real GDP per capita between 1978 and the early 1990s compared to that for other past and current developing countries.

This economic performance was seen by some as a bit surprising. This is especially so when the Chinese experience is compared with that for the transition economies of Central and Eastern European (CEE). This latter set of economies (such as Russia, Poland and the then Czechoslovakia) experienced negative rates of economic growth, from the late 1980s and into the late 90s, after these previously highly planned economies were reorganised in major ways during this period.

When China is compared with the CEE economies it is noted that whereas economic reform was introduced gradually and in measured sequence of stages in China, in the CEE economies the 'big bang' theory of economic reform was applied.<sup>1</sup> This 'big bang' policy requires that a great deal of change of economic institutions is carried out more or less simultaneously within a comparatively short period.

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<sup>1</sup> The exception was Hungary.

The natural question that arises is: Why was the gradualist economic reforms applied in China prove to be much more successful than the 'big-bang' reforms applied in the CEE countries?

One possible answer to these questions can be given by drawing on the theory of second best.

The theory states that, in an economy in which many distortions are present, the removal of one, or some, but not all of these distortions, will not necessarily make the community better off viz. (raise the community's level of social welfare) – it may, in fact, make the community worse off.

The intuition behind this result is that in an economy, where many distortions are present, these distortions may offset one another - at least to some extent. Hence, the removal of one of these distortions, which is assumed to be offsetting other distortions, will only distort the economy even further due to the presence of the distortions still remaining in the economy. The consequence is that the community is made worse off.

This point is demonstrated in figure 2 where is represented a production possibility frontier and a range of indifference curves (IC) for the community as a whole.

A single distortion, with no other distortion present, will put the economy at either  $P_1$  or  $P_2$ . When both distortions are present, however, these distortions offset one another to some extent and hence the economy operates at  $P^*$ . The removal of one of these distortions, while the other is still present, will move the economy to either  $P_1$  or  $P_2$ , depending on which distortion is removed. Being at either  $P_1$  or  $P_2$  places the community on a lower community indifference curve than if the community was as  $P^*$  - viz.  $IC^* > IC_1$ , and  $IC^* > IC_2$ .

Now there were many distortions in the Chinese economy in 1978 and in the CEE economies in the mid-1980s. Many of these distortions took the form of *a number of certain markets being absent or missing from the economy*. So what was missing from these economies, for example, were the services provided by a comprehensive legal system that is enforced (such a clearly defined and enforced system of private or group property rights), a wide range of financial services provided by a comprehensive banking and financial system, a comprehensive market for insurance, and the absence of many markets for goods that could compete with the goods

produced by monopolistic SOEs. In addition, in China in the early 1990s there was an absence of free markets for a range of factor inputs, since there still was some state planning of the distribution of these inputs, which implies that these inputs were rationed to some extent. Finally, in China the free mobility of labour was prevented by the *hukou* system.

Given this set of circumstances, attempts to reform the economy faced the community with a great deal of uncertainty – it was not at all certain if some particular economic reform would make the community worse, or better off.

In these circumstances it is preferable to reform the economy gradually by only reforming parts of the economy. Adopting such a strategy meant that if there were any serious adverse consequences resulting from this reform then remedial action could be taken promptly and relatively cheaply. This would not be possible if the ‘big-bang’ reform is approach is applied – once the reforms had been made they could not be reversed.

In addition, in a process that is still in progress (and will be so some time yet), various relevant institutions, that underpin a modern market economic system based on price signals, were gradually developed and introduced into the economy in the attempt to reduce the extent of the missing markets in China. For instance, TVEs were used to create group private property rights to offset the lack of private individual property rights.

This last change assisted with the development of competitive markets for goods (produced by TVEs) – goods that competed with those produced by SOEs. Thus even if the SOEs remained in the hands of the state, and were not privatised, the distortions the SOEs created (through their monopoly power) would gradually be reduced in size as a result of the creation of more competitive markets facilitated by TVEs producing goods that competed with those produced by SOEs. (It is being assumed here, reasonably, that the SOEs were faced with hard budget constraints in the long term (viz. they are not allowed to incur continuous losses).)

In addition, while all markets are not complete and/or undistorted, the theory of second best implies that it is best to allow a range of suitable distortions to remain present in the economy that offset other distortions (that are difficult if not impossible to remove) elsewhere in the economy.

The implications of these observations is that while the Chinese economy still contained a number of distortions in the late 1990s, overall these distortions gradually were reduced through a sequential set of changes in the economy that allowed distortions to be offset by other distortions in the economy, while the gradual creation of market conditions reduced the extent of other distortions.

Finally, the gradual reform of the Chinese economy allowed the identification of those reforms that were successful. These successes would reduce the perceived risks associated with future economic reforms and, hence, would tend to generate political support for some appropriate further economic reform. (If these reforms had been unsuccessful then the strength of political opposition to economic reform no doubt would grow.) This general issue of political support for economic reform will be returned to in a later lecture.

In contrast, as indicated earlier in the CEE economies the 'big bang' approach was applied. So, for example, there was the rapid privatisation of the SOEs. A consequence was that state monopolies were just turned into private monopolies. No attempt was made to establish industries that could compete with these monopolies and, thereby, reduce their monopoly power. Nor could new industries, which might compete with the monopolies, be established because of the weak economic institutional structure in these economies – such as missing relevant markets for various services such as enforced contract law and an incomplete set of banking, financial and insurance services.

The result of this privatisation was that there were increased levels of distortions in these CEE economies that were reflected in sharp increases in the level of unemployment, and the sharp reduction in the growth rates for these economies and the resulting loss of social welfare that these changes imply.

The lesson to learn from the comparison of the economic experiences of the CEEs and China in the 1980s and 1990s is that, for economic reform to be relatively successful in circumstances where there is considerable uncertainty as to how best to reform the economy, it is crucial to reform a distorted economy gradually and according to an appropriate sequence of changes. In this way political support can be generated for further economic reform.

In this process distortions are not necessarily removed but are offset by relevant changes introduced elsewhere into the economy. An important ingredient in this process is that missing markets are created with the provision of appropriate market institutions. Put differently, the general economic environment needs to be improved first (viz. create markets that were previously missing) before removing major distortions elsewhere in the economy – such as privatising SOEs. (This issue will be returned to later in the context of creating a social welfare system before attempting to privatize at least some SOEs.)

Not to reform a highly distorted economy in this way, and rush economic change – the ‘big bang’ approach to economic reform - is very likely to lead to creating an even more distorted economy than in the initial situation.

### **1993 up to the present.**

By the late 1980s it was recognised by an influential group of Chinese economists that it was time to introduce more wide ranging reforms into the economy. While, as indicated in the previous section, piecemeal reform had served China well in the 1980s, the stage had been reached by the late 1980s for more wide ranging reform, that was coordinated, was required.

Some of this reform had already begun before 1993 so that the dual-track pricing system in manufacturing industry was phased out to the point that 90% of all prices were determined by market prices.

Some parts of the economy, however, were finding that it was difficult to maintain economic efficiency due to changes elsewhere in the economy. So, for example, some TVEs in early 1990s had grown to a size that is had become difficult to monitor the behaviour of managers and workers in these comparatively large economic entities.

Thus there was a need to create institutions that allowed TVEs to be turned into private companies which would allow the managerial behaviour of managers and workers to be more closely monitored. In addition, other types of institutional change could allow the demise, without creating too much political opposition, of loss-making SOEs.

The fundamental requirement, that needed to be satisfied by the economic reform process from the early 1990s on, was the creation of basic institutions that were necessary if any other desirable and effective reforms are to take place. This process of creating these institutions is still in progress.

One of these fundamental institutions was the formal recognition by the central government that secure private property rights had to be created in China. (Without this recognition it would be impossible to create privately-owned economic entities that are fundamental for a freer market economy to function.) The beginning of this process of the formal recognition of secure property rights took place at the Third Plenum of the 14<sup>th</sup> Party Congress in November 1993. While at this meeting private ownership was only seen as a ‘supplementary component’ of the economy, by September 1997, at the 15<sup>th</sup> Party Congress, private ownership was explicitly recognised to being an ‘important component of the economy’. By Chinese standards this was a radical change in perception of the import role secure private property rights must play in the Chinese economy.

This change in perception was incorporated, in March 1999, into the Constitution of the People’s Republic of China where private ownership of property was recognised as a legal system of ownership.

Along with this change naturally there had to be a change in the legal system that would apply, or implement this concept so that individuals have legal rights protecting them from the confiscation, by the State, of their private property. The State, in turn, needs to be an impartial arbitrator in cases concerning the protection of private property, the enforcement of contracts and, in general, the regulation of a market system based a good deal on private property.

Part of this process of implementation took the form of the promulgation of the Lawyers’ Law in 1996. The court system, however, required to implement the law, is not always seen to be impartial. For instance the regional courts are not perceived to be impartial in their judgements – a plaintiff from the local region is favourably treated relative to a plaintiff from outside the region. Potential solutions to this sort of problem are reasonably obvious. (See Qian and Wu, p 120 – 22 in reading brick.)

Naturally, China really has only just begun to create a legal framework that would underpin a modern market system - which the CCP wants to see established. For instance there is no case law in China. This will take decades to create. But at least the process has begun.

Once an adequate legal framework for the protection of private property rights has been created it then becomes easier to reform other parts of the economy. For instance, now it becomes easier to create private enterprises. These new private enterprises may be completely new entities, or TVEs that are privatised. Indeed, the privatisation of TVEs began to occur apace from 1995 on. (Also see the relevant points made at the beginning of this section on TVEs.)

These enterprises in turn will create new employment opportunities. By implication, this change will make it easier, politically, to reform the SOEs since those employed in SOEs now will find it easier to find alternative employment opportunities should these individuals be made redundant by the SOE concerned being closed down or reduced in size. (A major block to reforming SOEs has been the likelihood that by reforming them a relatively large amount of unemployment will be created. This is seen to be politically unacceptable by the CCP.)

But reforming the SOEs also will require the reform of the social welfare system. In the past SOEs essentially have provided to their present and past employees housing, health insurance and life insurance and pensions. SOEs also were made responsible for paying compensation to employees who are made redundant. (It has been calculated that from the late 1980s on about a third of the labour force for SOEs has been made redundant.) Besides these expenditures placing a considerable financial burden on the SOEs, any attempt to radically reform the SOEs will tend to deprive these employees of these benefits. Such an attempted reform is bound to face stiff political opposition.

An alternative set of institutions need to be created if it is to be politically acceptable to have widespread reform of the SOEs. Besides creating alternative employment opportunities in the private sector, (i) one institution used is that the property rights to the housing provided by SOEs are transferred to present

and past employees. (ii) Another set of institutions that are being created are national pension and health insurance schemes. In short there needs to be reforms of the social welfare system as part of the attempt to reform the SOEs. (There are, however, a range of potential problems associated with the longer-term financial viability of these attempts to reform the social welfare system.)

Finally, there have been reforms of the systems used to manage international financial transactions, taxation, fiscal and monetary policy. All these particular reforms are dependent, at least in part, on the creation of private property rights.

### **Changes in the Industrial Structure of the Economy**

One of the consequence of the sequence of reform of the economy between 1978 and the late 1990s discussed above is reflected in the major changes in the structure of the industrial sector of the economy

Shares of total industrial output by enterprise:

Year	SOEs %	TVEs %	Private enterprises %	Other %
1978	77	22.4	0	0
1990	54.6	35.6	5.4	4.3
1997	25.5	38.1	17.9	18.5

The decline of the SOEs reflects, at least in part, the rise of TVEs and Private Enterprises. The rise of TVEs was made possible in the late 1980 and early

1990s by allowing by the relaxation of constraints on factor and product markets and the allowance of group-ownership of property. The reduced rate of expansion of TVEs in the 1990s (compared to the 1980s) and the comparatively rapid growth of Private Enterprises was the result of the increased level of legal recognition of private property rights from 1993 on.

Put differently, the data set out in the previous table reflects a wide range of economic reforms (particularly regarding the matter of property rights and the allowance of comparatively free output or product (if not factor) markets) that have taken place since 1978 to the late 1990s.

**Figure 1:** The influence of an increase in the labour supply, relative to the supply of capital, in the wage/rental ratio. Output per unit of labour ( $Y/L$ ) is a function of capital per unit of labour ( $K/L$ ). There is diminishing return to ( $Y/L$ ) as more capital is applied to labour - the ( $K/L$ ) ratio rises.

