

## Chapter 2

# Economic Transition and Theoretical Innovations

It is generally believed that the goal of China's economic transition is to establish a market economy like that of the United States. Some people even recommended that China follow the privatization and liberalization path as conceived by the Washington Consensus. However, the over-30-year economic transition undertaken by China since the late 1970s has shown that although a market economy and a private-ownership economy is expanding, China has not taken the same neoliberal path as suggested by Western countries. Most significantly, the ultimate goal of the transition in China is not to institute an American-style market economy, but rather one that incorporates socialism with Chinese characteristics. The achievements of China's 30-year economic transition have demonstrated that both China's model of economic restructuring and its path to economic development are successful.

### 2.1 Exploring a Socialist Development Path with Chinese Characteristics Based on China's Economic Conditions

After the founding of the Soviet Union, the first socialist country in the world, other nascent socialist nations all rushed to communism, attempting to put into practice the assumptions based on the classic Marxists about their economic systems. China in the 1950s also followed the Soviet Stalinist model of a planned socialist economy. However, this soon proved to have major limitations for raising levels of productivity. After the death of Joseph Stalin, especially in the 1970s and 1980s, the Soviet Union and Eastern European socialist nations embarked on the so-called market-oriented reform. This was not a mere abandonment of the Stalinist model, but rather a turn towards a capitalist system. The economic transition in China that started from the

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Third Plenary Session of the Eleventh CPC Central Committee, however, has not taken the road of the former Soviet bloc countries, but a socialist path with Chinese characteristics based on the idea that China is still in the primary stage of socialism.

The relations of production need adjustment in order to meet the requirements of the development of productivity. This process is not always one that moves forward smoothly. When productivity is impeded and destroyed by relations of production that are purposely and prematurely transformed, it is actually and ironically a great reform to make the premature relations of production regress to the stage where they match the development of productivity. This reform serves to liberate and develop productivity.

The primary stage of socialism refers to the specific historic stage that China must experience in order to build socialism. This stage will enable China to realize industrialization, socialization of the economy, and the modernization of the market. The conditions have been achieved in many other countries in capitalist circumstances. The principal challenge of this stage is the gap between the ever-growing material and cultural needs of the people and the low level of production. This challenge means that the task for the primary stage of socialism is to develop productivity rather than to eliminate private ownership, the latter being needed for the development of greater productivity. In accordance with this theoretical breakthrough, China's reform and opening-up for the past 30 years has successfully transformed the Chinese economy in the following four aspects:

The first transformation is in economic institutions. In economics, economic institutions reflect the fundamental nature of society and the essential characteristics of the relations of production. Economic systems are the concrete form of relations of production in a given society and belong to the institutional arrangement of economic operations. In general, the goal of economic reform in China has not been to change the socialist economic system, but to make new institutional arrangements in the context of socialism, such as turning to the market economic system and changing the way in which resources are allocated. That China is still in the primary stage of socialism, however, suggests that its economic reforms will inevitably conflict with the already formed socialist economic system. In other words, the target of China's economic reform is in accordance with maintaining a relationship with the current socialist economic system. The goal is to adapt to the primary stage of socialism and the current level of productivity. Therefore, on the institutional level, the achievements of the 30-year economic transformation lie in the establishment of a basic economic system for the primary stage of socialism, and the establishment of a socialist market economy.

The second aspect is the transition from a traditional society to a modernized one. The primary stage of socialism is a process that gradually breaks away from underdevelopment to achieve basic modernization. The central task of this stage is to develop the economy and transform society from a traditional one to a modernized one. For an agricultural country, modernization includes industrialization, urbanization, and the move toward a high-tech economy. It is necessary for a later comer to abide by the general rules of modernization and to adopt the basic course taken by countries already modernized. Meanwhile, a developing nation must pioneer

its own unique path to modernization, taking into account its own national conditions and the new economic, social, and political environments at home and abroad. Promoting the establishment of “a comprehensive well-off society” as part of its modernization process, China has taken a path to modernization with Chinese characteristics. In light of this goal, the transition of China’s economic and social development targets the following items: (1) the change from an agricultural nation with a large rural population and mainly dependent on manual labor to an industrialized country with a large non-agricultural population and an economy comprising modern agriculture and service industry; (2) the change from a largely natural and semi-natural economy to a market economy; (3) the change from a society with a large illiterate and semi-illiterate population and with underdeveloped science, technology, education, and culture to a society with advanced science, technology, education, and culture; (4) the change from a stage with large segments of the population living below the poverty line or at a low standard of living to a stage featuring better-off living conditions for all people.

The third aspect is the transition from a closed and semi-closed economy to an all-round open economy. China needs international resources and markets to develop its productivity. In the conception of scientific socialism, Karl Marx perceived capitalism and socialism as sequential when he deduced a future socialist economy that was non-existent in his time. In reality, however, capitalism and socialism have been coexisting for a long time. China, as a socialist nation, is relatively young, and its socialism originated from a semi-colonial and semi-feudal economy rather than from an advanced capitalist economy. But capitalist economies have been around for well over 200 years. Several significant industrial, scientific and technological revolutions first took place in capitalist countries. In addition, the economic organizations and economic forms representing advanced social productivity initially came into being in capitalist countries. Therefore, to develop social productivity, especially advanced social productivity, it is necessary for China to learn advanced technology and managerial experience from developed capitalist countries and to actively participate in international economic cooperation and competition so as to strengthen its own global competitiveness. It is essential for China to attract foreign capital through opening-up and to adopt all economic forms—even those practiced in capitalist economies—as long as they are conducive to the development of productivity. Furthermore, China’s economic opening-up means not only letting in foreign capital and goods, but also going out and fully participating in international competition in today’s globalized economy.

The fourth aspect is the transformation of the mode of economic development. In the early stage of its economic growth, a developing nation usually implements a “catch-up strategy,” hoping to catch up with the developed countries within a short period of time. This traditional, extensive mode of growth, merely pursuing “fast” growth, might succeed at the early stage of development because of the generally low level of industrialization, the non-intense market competition, and fewer constraints stemming from the environment and resources. With the comprehensive advancement of industrialization and the general development of the economy, the

extensive mode of growth will inevitably come to an end, making it necessary to change the mode of development, from pursuit of economic growth alone to the pursuit of economic progress, from pursuit of quantity to the pursuit of the quality of development. These changes involve: (1) The change from an economy depending mainly on investment and export to one depending on the coordinated effects of consumption, investment, and export; (2) The change from an economy driven mainly by the secondary industry to one driven by the coordinated development of all the three industries; (3) The change from an economy depending mainly on increasing consumption of material resources to one depending mainly on science and technology, the quality of labor, and managerial innovation; (4) The change from the traditional model of industrialization to a new path with Chinese characteristics, a path that seeks sustainability and harmony between people and nature. It has been proven that such a transformation of the mode of economic growth can lead to a path of scientific development and social harmony.

## **2.2 The Basic Economic Institutional Framework for the Primary Stage of Socialism**

The recognition of China in its primary stage of socialism means that China's socialist system is not yet fully developed and its socialist nature is not yet fully displayed. Specifically, this can be demonstrated in two respects in terms of the relations of production.

First, its structure of social production relations is not entirely socialist. It is a pluralistic structure containing multiple forms of non-public ownership. Different from other transitional economies, China's economic transition does not mean abandoning public ownership and adopting overall privatization. To develop the market economy, however, it is necessary to develop an economy of diverse forms of ownership, especially the indispensable form of a private economy. In this way, a basic economic system dominated by the public sector can take shape with the participation of diverse sectors. Within such an economic framework, a series of institutional arrangements can be set. The economic system is a socialist market economy; the income-distribution system is dominated by distribution according to work while a variety of distribution modes coexist.

Second, the socialist economic relations are still in the primary stage and have not reached the mature standard of socialism. This is reflected in the following areas. First, the level of public ownership of the means of production is not likely to be high. Public ownership takes more than one form, and various forms of public ownership have different ways of realization and modes of operation. Public assets, which do not have to be managed in full public-ownership enterprises, can be managed in mixed-ownership enterprises with private elements. Next, it is not really fair or sufficient to distribute according to work. The "work," be it in its fluid, latent, or solid state, cannot accurately reflect the contribution of the workers. In the

meantime, the same work in different departments and enterprises cannot be guaranteed equal pay. Finally, common prosperity is still far from reality. There will be a temporal difference between different regions, sectors, and individual workers in term of achieving prosperity.

Clearly, because of the characteristics of socialist economic relations in their primary stage, one important aspect of reform is to adjust the economic system, making it reflect the current primary-stage, not the future advanced stage, socialist production relations. Such relations consisted of the following components.

1. A basic economic system in which public ownership dominates and diverse forms of ownership coexist:

In the institutional framework, public ownership dominates and diverse forms of ownership coexist. The dominance of public ownership ensures its socialist nature. At the same time, both the coexistence of diverse forms of ownership and the dominance of public ownership exhibit Chinese characteristics. This is reflected clearly in the following areas.

First, the perception of the dominance of public ownership is changed. In the development of an economy with diverse ownership systems, it is inevitable to encounter the problem of maintaining the dominant position of public ownership. Traditional theories focused on the absolute public ownership of enterprises and defined the dominance of public ownership in terms of the dominant numbers of public enterprises, which in turn were limited to state-owned or collective-owned enterprises. China's reform practice has broken this dogma and made a theoretical breakthrough in that public-ownership is redefined as public-owned capital, including state-owned and collective-owned capital, rather than public-owned enterprises. Thus, the dominance of public ownership is endowed with a new meaning: Public assets dominate in total social assets, with the state-owned economy controlling national economic lifelines and playing a leading role in economic development. This theoretical breakthrough provides significant guidance to China's economic transition and reform. Now public assets do not have to be managed in entirely public-owned enterprises; instead, they can be managed in mixed forms of ownership containing private elements. And the dominance of public ownership reveals itself through the controlling power of public assets in mixed-ownership enterprises. Further, the state-owned economy will concentrate in the fields where it should play positive roles. They include national economic lifeline sectors such as railways, airlines, ports, post and telecommunications, and finance, and basic industrial sectors that are important to the national economy but are relatively weak, such as energy and raw material industries. The state-owned economy should maintain its dominance in these fields, whereas in other fields, which can be defined as competitive sectors, it should give up its dominance. Even in the national economic lifeline sectors controlled by the state-owned economy, total state ownership is not necessary, except in those sectors involving national security. It is feasible to grant some equity to non-public capital through a joint-stock system to allow them to enter these sectors.

Secondly, the institutional boundary has been crossed in the development of diverse forms of private-owned economy. In the past, the private economy, including foreign investment and private capital, was “outside the institution,” but now it is “inside the institution” and has become a part of socialist economic system. The development of a private economy has breached the institutional limits. Now foreign investment and private capital are allowed to enter those sectors once monopolized by state-owned enterprises, such as retailing, foreign trade, finance, insurance, communications, and even railways. The trend of development is that the non-public economy will be allowed to enter any area as long as it does not affect national security or violate Chinese laws. Thus, public ownership can take the form of mixed ownership, as specifically shown in the forms of joint-stock systems, cooperative stock systems, Sino-foreign joint ventures, and the joint-capital and joint-operation of various sectors of ownership. This change permits private-property rights to enter the realm of public enterprise. Therefore, the co-development of public and non-public ownerships occurs not only between enterprises but also within an enterprise. It means different types of ownerships can coexist in a single enterprise.

## 2. Socialist market economic system:

The goal of China’s economic reform is to establish a socialist market economy. Traditional theories linked the planned economy and market economy to different socioeconomic systems. They claimed that socialism must carry out a planned economy while designating capitalism with a market economy. One important point of progress made in China’s reform and opening-up is the re-categorization of the planned economy and market economy both as modes of resource allocation and the mechanism of economic operation. Be it in a planned economy or the market economy, the mechanism of economic operation does not reflect the nature of the economic system. In reality, capitalism has planning, and socialism may have to “market.” To improve the efficiency in allocating resources, it is necessary to establish a socialist market economy in which the market plays a fundamental role in resource allocation. Meanwhile, the government will strengthen macroeconomic adjustment and control. In this process, both the government’s macroeconomic adjustment and control and market mechanism play fundamental roles in economic adjustment and control. The former demonstrates the strength of socialist system while the latter is a characteristic of China in its primary stage of socialism. In other words, the former bears evidence of Chinese characteristics while the latter reveals a common feature shared by all the market economies.

To develop a market economy, the market mechanism must play a fundamental role in adjusting resource allocation so as to guarantee the efficiency of allocation. Toward this end, it is critical to enable the four mechanisms for resource allocation in the market to function well. The first one is the mechanism of equal exchange, a mechanism that is accepted by enterprises pursuing profits independently and that also allocates resources to different production fields according to the standard of socially necessary labor consumption. It is therefore necessary to push forward reforms in price-setting mechanisms, enabling the market to determine price. The

second one is the competition mechanism, which exerts external pressure on enterprises—the survival of the fittest. Resources are allocated competitively with the principle of efficiency, enabling the flow of resources to more efficient areas, sectors, and enterprises. It is therefore necessary to remove government protection and break market monopolies in order to form a freely competitive market environment. The third one is the information mechanism in which sellers and buyers meet directly, and the direct feedback enables quick information exchange and reduces administrative distortions. The fourth one is the mechanism of risk and benefit. Real competition will not exist until competitors bear the risks. Economic actors in the market economy should take risks. Actors should not only receive the benefits but also bear the risks brought by their own behavior. For instance, both investors and managers need to bear the risks for their investments and management decisions, and be responsible for their profits and losses.

To modify the market economy with the word “socialist” does not change the basic regularity of the market economy. Rather, it highlights the government’s role in macroeconomic adjustment and control. It not only serves to prevent market failures and macroeconomic imbalance, but also meets the requirements of a socialist system, particularly the requirement for equity and justice and the prevention of polarization. At the present stage, the government’s macroeconomic adjustments and controls also play the role of promoting economic development.

### 3. An income distribution system with multiple modes of distribution according to one’s labor contributions:

In traditional theories, the basic principle of socialism was common prosperity. Since only the labor factor was privately owned while all the other factors were publicly owned in socialism, socialist income distribution could only be distributed according to work. At the primary stage of socialism, however, because of the coexistence of diverse ownerships in the economy, the labor factor and other production factors are privately owned to different degrees. It is therefore necessary to allow the coexistence of diverse distribution modes. Due to the difference in the possession and mobilization of production factors between different areas, enterprises, and individuals, there is an inevitable discrepancy between those who enjoy prosperity first and those who lag behind. The discrepancy in the phenomenon of who becomes prosperous and when, must be accepted if efficiency is to be improved, allowing some areas and some people to enjoy prosperity before others. Here distribution according to work and common prosperity are the institutional characteristics of socialism, while the coexistence of diverse distribution modes and allowing some people to enjoy prosperity first are the Chinese characteristics of the present stage. With these theoretical definitions set, the following two effects brought by the reform will appear.

First, under the conditions in which various production factors are privately owned in different degrees, to mobilize all factors to develop productivity and to release the wealth-creating energy of the people, it is necessary to allow various production factors, such as capital, technology, and management, to participate in income distribution according to their contributions. It is necessary to allow people

to have not only labor income, but also property income and operational income. Since the production factors are owned unequally for different individuals and in different areas, the income gap will expand unavoidably if income is distributed according to the input of production factors.

In addition, it is necessary to maintain equity and justice in income distribution to realize the principles of socialism. To begin with, the equity rights in income distribution needs to be safeguarded. It is necessary to prevent power-money deals and the abuse of power for personal gains as well as to regulate monopolies. Furthermore, a proper balance should be maintained between efficiency and equity in both primary distribution and redistribution, with a particular emphasis on equity in redistribution.

Finally, those who enjoy prosperity earlier should be encouraged and guided to help those who lag behind so as to gradually achieve common prosperity.

After thirty years of reform and opening-up, China has accomplished and continues to accomplish the aforementioned aspects of an economic system in the primary stage of socialism. This is a basic socialist economic system with Chinese characteristics. It has demonstrated and continues to prove its advantages in promoting the development of productivity and the improvement of people's living standard.

### **2.3 The Ongoing Construction of a Socialist Economic System with Chinese Characteristics**

An economic system includes many subsystems interconnected with one another. The aforementioned economic system of the primary stage of socialism has come into being but is not yet complete, because the subsystems still need further transformation and construction. As the saying goes, the devil is in the details. The transformation and construction of the subsystems are crucial to the economic system.

#### **1. The transformation and construction of enterprise institutions:**

The transformation of enterprise institutions involves the construction of the micro-foundation of socialist systems with Chinese characteristics. Having confirmed that joint-stock systems can become the major form of realizing public ownership, be it the restructuring of state-owned enterprises or the development of private enterprises, the basic direction for the transformation of enterprise institutions is to establish modern enterprise institutions featuring a corporate system. Accordingly, the transformation of enterprise institutions has three aspects. The first is the transformation of the property-rights system, which means the construction of a modern property-rights system. It features "clearly-designated ownership, well-defined rights and obligations, strictly-implemented protection, and smoothly-flowed circulation" based on the diversification of the enterprise equity structure. The second is the



transformation of the enterprise governance structure. In modern corporations, the property rights of the investor and of the legal person are separated. Hence, the core issue in the corporate system is the legal person's corporate governance. Governance structure concerning the enterprise stakeholders involves relationships between the enterprise and government, between enterprise shareholders, between shareholders and managers, and between managers and employees. To improve enterprise governance structure, it is not only necessary to set the obligations, rights, and benefits for managers, but also to achieve investor's targets, i.e. maintaining and increasing the value of assets through establishing a set of effective institutional and contract arrangements, especially the supervision and motivation of managers. Third, it is imperative to strengthen the motivation for and restraint on enterprise managers, turning the managers into entrepreneurs institutionally.

For those low-efficiency or poor-quality enterprises, it is impossible for all of them to walk out of difficult situations by transforming their enterprise systems. Therefore, the transformation of enterprise systems will unavoidably follow the rule of the survival of the fittest, which makes corporate restructuring necessary. Corporate restructuring may become a shortcut and efficient path for the transformation of enterprise institutions. It can be achieved through strong enterprises merging and acquiring the weak or through the mutual merger and acquisition between enterprises of different ownership types. All these processes witness the flow of property rights between different enterprises. Such corporate restructuring can effectively solve the problem of equity diversification required by the corporate system, and may also improve the overall effectiveness of the enterprises under transformation.

## 2. The construction of a market system:

China is a latecomer in the development of a market economy, but it may start from a high level. That is to say, it should be a modern market economy that cooperates with socialism. To meet the standards of a modern market economy, the establishment of the market system mainly consists of the following three aspects.

First, it is important to build a modern market. The previous planned channels, having already reached quite a high level after decades of construction and development, cannot be replaced by low-level markets. Market in the modern sense is not merely a place for exchange, but a mechanism for connecting exchanges and making deals. Therefore, the key in market construction is to strengthen market connections, including training and guiding the players in the market, building the network for supply, production and sale, and improving the means of disseminating market information. According to the standards of the modern market, we should focus on building various modernized wholesale markets, specialized markets and futures markets, and setting up market networks with modern science and technology. More important in the transition from a planned economy to a market economy is the entry of production factors into the market and the formation of a market system with all the necessary factors. Only when various factors enter the market system can a market economy come into being. All the production factors

have to be fully involved in the market. At the present stage, well-functioning capital and labor markets are in urgent need.

Secondly, it is significant to establish a sound market mechanism. The market's effective regulation of the basic allocation of resources is the key, as reflected by the operation of the market mechanism. Specifically, the mutual dependence and flows among market factors such as marketing, competition, price, and supply and demand must correspond to the law of value. To overcome the institutional barriers arising from various market factors, China needs to build a market mechanism that addresses the following three areas. The first is to transform government-established price mechanisms into those determined by the market. It will allow prices to follow the market, thereby eliminating price rigidity. The second is to impose further restrictions on company budgets, which will force enterprises to move from their previous dependence on the government to relying on the market. Finally, we must break monopolies and end government protection to intensify competition in the two areas. All enterprises will have to compete for profits based on their own strengths, under a unified state policy.

Finally, it is imperative to establish market norms and orders. The free competition and independent management required by a market economy are by no means disordered or without rules. Only when competitors abide by certain norms can a market economy operate with order and efficiency. The efficiency of the way the market adjusts in the allocation of resources is determined by whether the market mechanism can function effectively. Specifically, the effectiveness of the market means that the mutually-restraining connection and movement between market factors, including market, competition, price, supply, and demand, should follow the law of value. It is therefore necessary to make market norms with the purpose of forming a full-fledged market mechanism. Faced with the institutional obstacles encountered by various factors operating on China's market, the establishment of the market system mainly includes three aspects. First, norms for pricing should be established when the price is determined by the market after pricing deregulation. We need to restrict monopolies, dumping, and profiteering in pricing so as to prevent any drastic fluctuations of prices. In addition, competition should be strengthened by breaking monopoly and government protection so that enterprises can gain profits only through their own competitiveness. Norms for competition, including norms for market entry, market competition, and market withdrawal, must be established in an open competitive market. At the same time, strict rules and regulations must be made to protect fair, just, and open market competition and to increase market transparency. Finally, strict rules must be established for the speculative markets. Strict rules have to be made in high risk and speculative securities and futures markets as well as foreign exchange and real estate markets in order to protect the legal rights and benefits of investors. These rules include self-discipline rules, unified market laws and regulations, law-enforcement systems, and regulation to increase market transparency.

### 3. The construction of a macro adjustment and control mechanism:

A market economy means the transformation, rather than the weakening, of the macro adjustment and control mechanism. Basically, direct control is changed into indirect adjustment, turning from the direct control of the enterprises in the past to adjusting the market in the present. Even for products that need to be under the direct control of the state, the government no longer controls them directly through mandatory plans but acts as a market participant to procure them. In this case, the construction of macro adjustment and control mechanisms mainly involves the following three issues. The first is the demarcation of boundaries between the government and the market: The government does not need to intervene wherever the market can function effectively, especially in microeconomic fields. The second is the specification of the content of macro adjustment and control. The government adjusts and controls the general market price level to maintain order for market competition rather than pricing the products directly, as it did in the past. The third is improving the means of macro adjustment and control. The government control changes from directly issuing quantitative plans and quotas, as was done in the past, to the current means of adjustment through policies and norms. Such policies and norms include government regulations for market, fiscal, and monetary policies making for total equilibrium.

The socialist market economy in China endows the government with a significant role in macro adjustment and control. It in turn demands that the government's macro adjustment and control be more scientific. Toward this end, efforts should be made to achieve the following three major goals.

First, it is necessary to set up government agencies to adjust, control and supervise the market. For example, the financial adjustment mechanisms should be transformed. Based on the establishment of commercial banks and the commercialization of state-owned specialized banks, China has set up a central bank system and corresponding monetary-adjustment system, in addition to various financial agencies such as the Banking Regulatory Commission, the Securities Regulatory Commission, and the Insurance Regulatory Commission.

Secondly, it is important for a government that adjusts and controls the economy to transform itself. The goal is to allow the market to play a critical role. It is generally believed that in a market economy a "strong" market should be matched with a "weak" government so that the market can function to the fullest. However, the experience of China's reform and development has shown that a "strong" market could well coordinate with a "strong" government, provided that the two play their roles on different operational levels. In the past, the government focused mainly on economic construction, and therefore, it might have friction on this level with the market. The trend in government reform now aims to reduce its role in economic construction and administrative intervention, gradually narrowing the focus of government at all levels to "economic adjustment, market supervision, social management, and public service." There are two aspects to transforming the function of government. One is the transformation into a public-finance system. The other is the transition towards the rule of law. Governance should rely mainly on

laws rather than on policies. These transitions are currently in progress in China and have achieved outstanding results.

Thirdly, it is vital to strengthen the construction of the legal system and to turn the government into an administration ruled by law. In a market economy, the most important laws are property law, contract law and anti-trust law. Laws for the market must be established and enforced in the market to ensure that market order can be kept voluntarily. Under such circumstances, the government administers the country mainly through rule of law rather than policies.

In summary, China's 30-year reform and opening-up is a marvelous process with impressive achievements. The viability of a socialist society with Chinese characteristics can be seen in the results of the practice of economic transformation. The truth and value of the theoretical achievements of socialism with Chinese characteristics have been tested and are being tested by practice. Today, as we commemorate the 30th anniversary of China's reform and opening-up, we are more determined to hold high the great banner of socialism with Chinese characteristics and to continuously and firmly push forward the great cause of reform and opening-up.

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