ECON4940 Understanding and Interpreting Chinese Economic Reform, Spring 2006

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Lecture note 3: China as a command economy. How to reform a centrally planned industrial sector?

Wu (2005), Chs. 1.2.3, 1.3, 1.4 and 2.1 (2.2 and 4.1).

1.1 Introduction

The paradoxes of the Chinese economic reform.

It has been called “the strategy of not having a strategy” and also the strategy of “just muddling through”. A well known author on China coined the phrase “growing out of the plan” as a description of what happened.

A few years after the beginning of the Chinese reforms the collapse of the Soviet bloc occurred and “experts” on transition appeared on the scene and gave advice on how to transform planned economies to market economics. The transition process that had been initiated in China ran counter to much of the expert advice given in Europe.

1.2 The command economy

The Chinese economic system before the reform was a <u>command economy</u>, mapped very closely upon the model of the Soviet Union. So was also the economic system of the CMEA countries of Eastern Europe. The fundamental similarities of command economies make the problem of transition from a command economy a market economy pose a similar challenge. The way these countries have faced transition, particularly China versus the others, is very different and it may give some insight to consider these differences.

Although China modeled its command economy on the Soviet model, there were differences. China was a much poorer country. Its lower level of development, meant in a sense a less perfect planning system and that is related to the reform options and the growth prospects. A major difference was that the Chinese system was less centralized.

The Soviet-type command economy was a refined and comprehensive system. Its interlocking institutions made the problem of economic reform very difficult. Its key features were (1) that resource allocation decisions were made in response to commands from planners, rather than as a response to prices, and (2) a large volume of resources were concentrated in the hands of the planners. The planners decided the investment program and the command economy was designed to channel sufficient resources into investment.

Although these are the essential characteristics, command economies also share a number of subsidiary features.

Characteristics of Soviet-type economic strategy

1. High rate of investment, over 25 % of GNP
2. Priority to heavy industry and military
3. Priority to investment in goods-producing capital, neglect of services
4. Investment in basic needs: health and education
5. Preference for autarky: limited importance of foreign trade

Naughton (1996, p.27)

Characteristics of Soviet-type economic system

1. Public ownership of productive enterprises

   a. State ownership of large-scale industry and wholesaling
   b. Collective ownership of agriculture

2. Material balance planning

   a. Quantitative output commands
   b. Allocation of commodities to match sources and uses

3. Nomenklatura system controlled by the Communist Party
4. “Monobank” extends credit passively to accommodate plan
5. Material incentives (except in China during the Cultural Revolution) and hard budget constraints for households.

Naughton (1996, p.28)

Macroeconomic characteristics of the command economy

1. Household income is modest share of household income, typically less than 60%. Large share of income accrues directly to state or state enterprise sector
2. Household saving is small, and bulk of national saving is carried out by state-owned enterprises
3. State carries out most investment, financed by transferring state enterprise revenues to the budget. Tax system is implicit in government control of price system
4. Bank lending restricted to short-term finance of trade and inventories
5. Persistent shortages of goods

Naughton (1996, p.31)

How well did this kind of system suit China and how China adapt to it?
The development strategy’s emphasis on heavy industry was not equally suitable for China as for the Soviet Union. China was richly endowed with labour power, but short of land and capital. Early development of labour-intensive industries may have been a wiser choice.

THE MATERIAL BALANCE SYSTEM

THE EXTREME COHERENCE OF COMMAND ECONOMIES MAKES THE DIFICULT TO REFORM

1.3 The pre-reform economic system of China.

China before 1978 was definitely a command economy. China differed from the Soviet Union in the endowment of both resources and skills and was a much poorer country. China was indeed among the poorest countries in the world. The structural transformation on the path from a traditional to a modern economy was far behind that of the Soviet Union and the CMEA countries, in particular the rural sector was much larger. These differences left its mark on the Chinese command economy.

China's output per worker both in agriculture and in industry naturally was lower than in other economies. The lower skill level was part of the explanation. Shortages of skilled manpower also meant that the command system itself was more poorly equipped with skilled manpower, such as engineers. China was an underdeveloped country, although compared to other countries at the same level of income per capita it was in several ways better equipped due to its "cultural traditions" (e.g. entrepreneurial traditions, higher literacy, familiarity with large-scale organizations).

The poverty of China also meant infrastructural limitations in communication and transportation, etc. The build-up of skills took place rapidly, however, until the severe interruption of the Cultural revolution. (Available data seems to indicate that 4% technicians in the industrial labour force in the mid-1960s went down to only 2.6% in 1976, and did not reach the 1965 level until 1987!).

China's industry was much less concentrated that in the Soviet Union, perhaps partly a sign a less developed command system, but also reflecting geography. Although China is smaller that the Soviet Union was, it is more divided up by geography.

The Soviet Union had just above 40,000 state-run factories in 1979 and factories with over 1000 workers accounted fro 74% of Soviet industrial output and 75 % of the work force. In China factories with over 500 workers accounted for a little over 40 % of industrial output and there thus were many small and medium-sized factories. China had 83,000 state-run factories in 1978, plus 100,000 urban collectives. (What a 'collective' is as a production unit in China is problem to all new students of China, perhaps we can clarify that at the seminar next week.) In addition there were several hundred thousand small rural factories.

This we have established that the Chinese production apparatus run by the command planning was more diverse, with more and smaller units, and also with a much higher rural share than in the SU. These features might suggest less emphasis of centralized administrative control, which also was the case. That can be quantified by the number of commodities under strict control. That number never came higher in China than around 600. That level was reached in SU around 1940, but it continued to rise to 1600 in 1951 and in the 1970s to 60,000.

The low number in China implies that commodities were in fact lumped together in aggregates, hence it was kind of crude or incomplete allocation schemes. Furthermore, local governments played a considerably greater role in production than in SU. For key commodities such as cola, steel and cement local governments took very active part an din the mid-1970s produced 50% of cement, 25% of finished steel and 40% of coal. Thus unlike the extremely centralized command system in the SU China had a more partitioned system, which at the end of the day may have contributed much to its flexibility wrt. reform.

The Chinese command system seems also to have functioned in a more relaxed way. The plans could have shortfalls or gaps which need to be filled from local sources and it has been observed that the production programs given to individual state-run factories were much less tight and constrained than in the SU. Also financially, resources were much less centralized than in the SU. The local governments in provinces and big cities had considerable leeway for mobilizing resources. But this should not be understood as local autonomy, only as ability to act in a supplementary way under the directions handed down from Beijing.

Strict central control was exerted with regard to the development strategy, usually with strong ideological overtones. The control was very strict wrt. labour mobility and remuneration, and also with regard to agricultural procurement and commerce.

There was also a clear element of making the regions self-supplied in various ways. Provinces were at one stage encouraged to be self-supplied in supporting the rural sector with everything needed, such as building materials, energy, fertilizer and implements, while the central government insisted on complete central control over procurements for agriculture.

The allocation of labour power has some special characteristics in China, foremost that employment in state-owned enterprises became permanent employment. Many employees spent their entire life in the same enterprise and often arranged to have their children start there too. State enterprises could also make use of more temporary employment, but the permanent employment was the characteristic feature, a real life-long contract between employer (state) and employee and much more comprehensive than what we regard as employment. There was thus not much labour mobility in the cities. And added to this there was very strict control of migration from rural to urban areas.

The permanent employment in the state-owned enterprises had a kind of counterpart in the membership in people’s communes, wrt. permanency but not in terms of advantages. A special feature during the Cultural Revolution was the many youths, in total 17 millions, who were sent to the countryside. CONSEQUENCES

A date item here: In 1979 there was according to Chinese statistics 22,000 quits or fires of state employees, i.e. 0.03% of the labour force!

The wage system in the state-owned enterprises was flat rate wage, no piece-rates or bonuses, like in the SU. The enterprises had no autonomy to influence wages. Permanent employment and the same wages for all was not exactly a good incentive system. One would think that the maintenance of such a system would imply low incentives and misallocation of labour. It has been explained or interpreted as a control measure after the GLP and the flight of millions from rural areas to cities with famine as a result.

Another part of this control system that was in place in the 1960s and 1970s was the strict control over agricultural procurement and consumer goods. Basically all vital consumer goods were rationed. Food products were typically rationed by monthly ration coupons for cooking oil, meat, eggs, coal, tofu, sugar et al. For cloth it was annual rations. There would be waiting lists bicycles, sewing machines and several other goods. Peasants were forbidden to bring goods into the cities and also urban free markets which had existed were closed from the beginning of the Cultural Revolution. But rural markets had been reopened after GLP and urban residents could go there to buy goods. But key commodities such as grain and cotton were not on sale even there. There were also few shops, in 1978 only one retail outlet per 914 residents, compared to 331 in 1957. People some times found their way around such restrictions.

Some attempts of further decentralization were done around 1970 and some provinces tried to establish their own material balances. Although the system delivered growth rates because of its built-in ability to mobilize investment, it performed poorly in many ways. Inventories piled up and big projects remained incomplete for years. In the late 1960s and early 1970s China pursued the so-called Third Front program, which in every way was a detour and a great waste of resources.

The official growth rate of “net material product” from 1952 to 1978 was 6% a year or 4% per capita growth. That is a quite substantial growth rate, but the corresponding increase in living standards was very poor.

After the turmoil of the Cultural Revolution ended by Mao’s death in 1976, China’s leaders found that they did not really have good control over the industrial apparatus and that agriculture was not in a good condition. Did they look around in the world to see that there could be a considerable potential for China, if the comparative advantages were exploited through trade which still was very small? China could at this time study the experiences of some other Asian countries. No, the thinking went strongly in the direction of restoring and reinforcing the command economy.

A big effort was undertaken immediately after 1976 to restore the command economy and prepare a very comprehensive and also extremely optimistic ten-year plan, that failed practically before it had started.

RESISTANCE TO REFORM RURAL VS URBAN

1.4 Can command economies be reformed?

The attempted rationalizing reforms of the 1960sa and 1970s vs. the big bang reforms from 1990.

THE PROBLEM OF REFORM A COMMAND ECONOMY

1.5 The dual-track system

The ‘dual track system’ can be used to characterize the Chinese reform of a command economy by small steps from 1979, after the failure of the preparation of the ten-year plan in 1977-78.

shuāng guǐ zhì [双 轨 制]

It means the coexistence of the traditional plan for allocating commodities throughout he economy and at the same time a market channel for allocation. The dual-track also means two prices for the same good, a two-tier price system, a low state-set planned price and a market price, often much higher. It seems a dangerous system in view of the possibilities of moving goods from one system to the other, which also turned out to be a problem, and to some extent still is.

The dual-track thus refers to the coexistence of two coordination mechanisms, not to two ownership systems. It is true that the reform period also opened for more private production, but the main thrust of the dual-track was that the state-owned enterprises took part in both tracks. They were assigned production and delivery quotas, but with additional capacity they could also produce market goods.

Thus it was not a shrinking state sector still strictly within a command economy and a growing privately owned market sector outside it, but a system that allowed the state-owned firms to transact and cooperate with non-state, marketized firms. Hence, the dual-track is primarily related to the state-owned sector as the firms outside, collectives, private and joint ventures were predominantly market-oriented all along.

It is in this setting that the characterization coined by Barry Naughton of “growing out of the plan” becomes meaningful. The state-owned enterprises might still have the overwhelmingly part of their production capacity determined by planning commands, but a slong as this part tended to stagnate it was the small market oriented part that increasingly came to have influence on investment decisions. It was “market prices on the margin.”

References

Naughton, B. 1996, *Growing Out of the Plan. Chinese Economic Reform 1978-1993*, Cambridge: Cambridge University Press.