Economic Reform without Losers: Twenty Years of Chinese Experience (1979-1999)

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Collaborators

- Ying-Yi Qian and Gerard Roland
- "Pareto-Improving Economic Reforms through Dual-Track Liberalization," Economics Letters, Vol. 55, No. 2, 1997, pp. 285-292.
- "Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition," The Journal of Political Economy, February, 2000, forthcoming.

Economic Reform without (Absolute) Losers

- The meaning of economic reform
  - Introduction of markets in a centrally planned economy
  - Removal of restraints on economic activities
  - Opening up the economy to foreign trade and investment
- The meaning of losers
  - Absolute losers versus relative losers
- Can economic reform be achieved without creating losers?
  - In principle, yes, with lumpsum taxes and transfers from potential winners to potential losers

Economic Reform without Losers: The Desirability and the Difficulties

- The Desirability
  - Political support for economic reform is maximized ex ante
  - Political opposition to economic reform is minimized ex ante
  - Political opposition to the reversal of economic reform is maximized ex post
  - Potential downside losses and hence economic and political risks are minimized--the ideal way to implement a strategy of “feeling the stones to cross the river.”
- The Difficulties
  - Imperfect information
  - Difficulty of targeting the potential winners and losers with general taxation schemes
  - Explicit lumpsum taxes and subsidies are virtually impossible
  - Costs of information and implementation

Implicit Principle of Chinese Economic Reform: No One Should be Made Worse Off

- "Grandfathering" of the status quo ante
  - Protection of "vested interests"
  - Discriminating between the old and the new, e.g. two-tiered wage system
- Linked versus separated markets
- Importance of new resources
  - Availability
  - Efficient utilization

Sufficient Condition for Economic Reform without Losers

- The original prior allocation before the reform must be actually attainable given the endowment of goods, including enforceable entitlements, after the reform

The Chinese Economic Reform (1979-the present)

- The Open Door
  - International Trade
  - Foreign Direct Investment
- Marketization
  - Introduction of Markets in Goods, Factors and Foreign Exchange
  - Phasing Out the Plan

The Chinese Economic Reform (1979-the present)

- Devolution of Economic Decision-Making Power
  - Empowering Provincial and Local Governments
  - Professional Management of Enterprises
  - Autonomy and Incentive

The Chinese Economic Reform (1979-the present)

- Creation of New Modes of Organization for Production
  - Agriculture (1979)--Abolition of communes; the return to a system of individual cultivators with fixed rents and taxes
  - Industry (1984)--Emergence of “Township and Village” enterprises (TVEs); (foreign) joint-venture, foreign and private enterprises
  - Corporatization of state-owned enterprises (1997)

Examples of Economic Reform Without Losers from the Chinese Experience

- (1) The agricultural reform
- (2) The industrial reform
- (3) The introduction of the Foreign Exchange Certificates
- (4) The foreign exchange reforms

Examples from the Chinese Experience

- (5) Special economic zones, material processing and assembly, and foreign direct investment
- (6) The tax reform of 1994
- (7) The furloughing of the surplus labor of state-owned enterprises

The Agricultural Reform of 1979: An Application of the Dual-Track Approach

- The contract responsibility system:
- The commune is assigned the <u>responsibility</u> to
  - (1) sell a fixed quantity of grain (or other) output to the state procurement agency as previously mandated under the plan at predetermined (plan) prices and
  - (2) to pay the previously plan-mandated fixed amount of taxes to the state
- It is also assigned the <u>right</u> to
  - (3) receive the previously plan-mandated fixed quantity of inputs, principally chemical fertilizers, from state-owned suppliers, again at predetermined (plan) prices.
- Subject to fulfilling these conditions, the commune is granted
  - Autonomy in production and sale decisions
  - Incentive as the residual claimant to any profit

The Agricultural Reform

- The commune reassigns the collective responsibilities and rights to the individual farm households, allocating to them their shares of the commune's land (on a 15-year lease) and capital, and chemical fertilizers, and making them individually and directly responsible for the fulfillment of their shares of the delivery quota and taxes.

The Dual-Track Approach (1): A Centrally Planned Economy

- Enterprises and households are assigned rights to and obligations for fixed quantities of commodities at fixed plan prices
- The rights and obligations are enterprise- and household-specific
- They can be interpreted as simultaneous put and call options held by the producer and user respectively but exercisable at the same fixed plan prices
- There are governmental sanctions for failure to fulfil the obligations under the plan

The Dual-Track Approach (2)

- The “Plan Track”--the pre-existing central plan remains intact and its rights and obligations continue to be enforced by the government
- The “Market Track”--the market is instantaneously open, with price determined by supply and demand
- Producers are given autonomy and incentive to plan their production and participate in the market (at the margin), provided obligations under the plan are fulfilled

Two Types of Dual Tracks and Two Types of Market Liberalization

- Separated Dual Tracks (Limited Market Liberalization)
  - No transactions across tracks are permitted
  - Market resales of plan-allocated goods by either enterprises or households are not permitted
  - Market purchases by planned suppliers for fulfilling plan-mandated delivery quotas (e.g. sub-contracting) are not permitted
- Linked Dual Tracks (Full Market Liberalization)
  - Market resales and market purchases for redelivery are all allowed by a planned supplier or a rationed user, as long as the rights and obligations under the plan are all fulfilled
- For agricultural reform, the dual tracks are linked

Dual-Track Approach Leads to Pareto-Improvement

- (1) The dual-track approach with either limited or full liberalization of the market track is Pareto-improving; and
- (2) The dual-track approach with full liberalization of the market track achieves economic efficiency.

Limited Market Liberalization

- Efficiency cannot be achieved because
  - Inefficient suppliers will continue to supply after the economic reform
  - Inefficient rationed users will continue to consume after the economic reform
  - There will in general be over-production
- Full market liberalization is necessary for economic efficiency

Conditions for Pareto Optimality and Efficiency

- (1) the feasibility of the original plan;
- (2) the granting of autonomy and incentive to economic agents for their participation in the market on the margin;
- (3) full market liberalization--the allowance of resales of plan-allocated inputs, purchases of outputs for redelivery and subcontracting; and
- (4) the continued credibility of the state in both enforcement of the rights and obligations under the original plan and commitment to non-ratcheting

The Agricultural Reform: No Losers

- The commune and its individual members were no worse off
- The state was no worse off
- As long as the state was not worse off in terms of the quantities of grain and other outputs and taxes delivered to the state, it would continue to be able to supply the urban consumers with food grains and industries with agricultural raw materials (such as cotton) at plan prices, with the consequence that even the urban consumers and industrial enterprises would be no worse off
- Thus, the agricultural reform would be Pareto-improving for all parties as long as the original plan was effectively enforced

Examples from the Chinese Experience: Linked Dual Tracks--Industry

- Plan track at the enterprise level
  - The plan-mandated delivery quotas as well as the quantities of plan-allocated inputs for each enterprise and their plan prices were frozen at their then-existing levels
  - Fixed plan taxes and profit remittances
- Market track at the enterprise level
  - Contract responsibility system--must fulfil plan-mandated delivery quota, profit remittances and taxes
  - Autonomy in production decisions
  - Incentive as the residual claimant
  - Market purchases of output to fulfill the delivery quota is permitted (an example of full market liberalization); enterprises are not required to actually produce the output itself
  - Entry of new enterprises

The Industrial Reform: No Losers

- Planned profits and losses (taxes and subsidies) of enterprises remain the same
- Differences between plan and market prices make feasible lumpsum transfers
- Continued employment of workers by SOEs provides social safety net
- Continued planned consumer goods deliveries enable the maintenance of the pre-reform standard of living as a floor
- Thus, the “dual-track” approach is by definition Pareto-improving as long as the original plan is effectively enforced

Examples from the Chinese Experience: Foreign Exchange Certificates

- The Foreign Exchange Certificates (FECs) were required to be used by foreign tourists from 1985 to 1994
- They were available at fixed plan exchange rate
- Certain goods could only be purchased with FECs
- One objective of the FECs is to prevent the purchase of imported goods or goods produced for exports by the domestic population
- Another objective is to permit price discrimination (The price in FEC and the price in Renminbi could be different)
- The impact on the domestic economy as a result of tourism was minimized

Examples from the Chinese Experience: Swap Market for Foreign Exchange

- Plan track
  - Centralized foreign exchange receipts through centralized export operations
  - Central reallocation of available foreign exchange at fixed plan (official) exchange rate
  - Compensation for changes in the plan (official) exchange rate
- Market track
  - Swap market for qualified exporters and importers at market exchange rate
  - Retentions by foreign exchange earners at the margin
- There are no losers--enterprises, the state (urban and rural consumers) so long as the plan is enforced

Phasing out the Dual Tracks: Unification of the Foreign Exchange Markets

- The official and swap markets were unified on January 1, 1994 at the swap market rate
- Foreign exchange certificates were abolished at the same time
- 5-year lumpsum subsidies for establishments with plan-allocated foreign exchange at the pre-reform exchange rate
- One cannot say that there were no losers because the lumpsum subsidies were not forever but a 5-year phase-out period contributed greatly to the smoothness of the transition

Export Processing Zones and Special Economic Zones: Separated Markets

- Special Economic Zones
  - Minimization of interaction with and hence disruption of the domestic economy
  - Material processing and assembly activities (all of the inputs, except labor, are imported and all of the outputs are exported)
  - No disruption to the domestic economy, labor being in surplus
  - Labor is hired indirectly through labor subcontractors, paid a plan track wage rate but the foreign investors charged a market track wage rate
  - The same rule applied to foreign and joint-venture enterprises operating in China (subcontracted employment of labor, export requirements)
- There are no losers--foreign investors, domestic enterprises, the state, and the workers--so long as the separation is enforced
- In time, the enterprises in the special economic zones as well as foreign and joint-venture enterprises were allowed to buy and sell on the domestic market at market prices--there are still no losers so long as the plan is enforced

Examples from the Chinese Experience: The Tax Reform of 1994

- A nation-wide value added tax was introduced
- The fiscal contracting system under which the provinces would collect the taxes, sent a fixed amount to the central government and retained the rest was replaced by direct collection by a national revenue service and revenue-sharing
- The provincial governments were guaranteed revenue no less than that of their 1993 actual expenditures for the three years between 1994 and 1996.

The Furloughing of the Surplus Labor of State-Owned Enterprises

- Overpaid relative to the market wage rate
- Furloughed at a percentage of their pre-existing wages with their benefits (housing, education, health care) intact
- Autonomy to seek alternative employment (at the market wage rate) or to become self-employed or to withdraw from the labor force
- Neither the enterprise nor the workers are worse off

Efficient Utilization of New Resources: Economic Reform without Losers

- New enterprises and new activities have been responsible for the phenomenal economic growth of China
- Old enterprises did not lose
  - Continued "subsidies" for "planned losses"
  - Little or no privatization of existing enterprises
  - Little or no restructuring of existing enterprises
- High domestic saving rates of 35-40% provided the new resources and makes it less necessary to redeploy old resources
- Almost 90% of the fixed capital stock in 1998 is due to gross fixed investments made since 1979
- A real GDP expanding at 10% p.a. makes it much easier to assure that there are no losers
- Growing out of the "Plan"--the planned sector shrinks relatively as the aggregate economy grows at 10% p.a.

The Importance of the Point of Reference

- While it is possible to achieve economic reform without losers with a single stage reform, it is in general difficult to assure that there are no losers at every stage of sequential economic reforms,e.g.:
  - from limited market liberalization to full market liberalization
  - extension of special economic zone privileges to the entire country

Examples of Prospective Reforms

- Housing reform--raising rents to market levels coupled with a simultaneous and equivalent increase of salaries
- Pension reform--transition from an unfunded (pay-as-you-go) system to a defined contribution, fully vested individual account system
  - Perpetual floating-rate bonds so that the transition costs are shared by all future generations
- Chinese accession to the World Trade Organization--lowering tariffs on automobiles may drive some Chinese automobile manufacturers out of business
  - The Chinese automobile manufacturers can be given the right to sell the same number of automobiles, at the pre-WTO price, to the pre-WTO purchaser

Is Chinese Economic Reform Gradualist?

- Chinese economic reform <u>appeared</u> gradualist because
  - (1) sequencing of reform by sectors--agriculture, industry, international, labor and capital
  - (2) the population is protected from shock because of the policy of no losers
- For each of the sectors the markets were opened instantaneously just like “Big Bang”

Concluding Remarks

- Economic reform without losers is possible
- Political stability and credibility of the state are essential for its success
- Moreover, economic efficiency can be achieved under certain conditions (e.g., linked dual tracks or full market liberalization)