The Developing Economies, XXXIV-3 (September 1996)

BOOK REVIEWS

Growing Out of the Plan: Chinese Economic Reform, 1978–1993 by Barry Naughton, Cambridge and New York, Cambridge University Press, 1995, x + 379 pp.

It has been seventeen years since China embarked on economic reforms in the late 1970s. The new measures set off a period of high growth during which the Chinese economy evolved from a command to a market-based economy. Not only has economic growth been rapid in this period, its pattern has differed from the pre-reform years. Efficiency gains have begun to account for a sizable part of output expansion since the late 1970s.[1] With the systemic transition largely completed, this is an appropriate moment to review outcomes and draw lessons from China's economic reforms. Considering the subject's scope and complexity and the inadequacy of standard economic theory for explaining systemic transition, the task is not easy. Naughton's book deals squarely with the transformation that has taken place at the core of the planned economy and offers a comprehensive analysis of the reforms and their dynamics. Through an examination of the industrial sector and macroeconomic policy (the book largely neglects agriculture and foreign trade), Naughton provides a good portrait of China's reform policies and implementation process and presents a solid account of China's accomplishments up to the first half of the 1990s.

China's reform process is full of riddles. The questions appear all the more challenging if China's experience is compared with those of former European centrally-planned economies or considered against the conventional wisdom of economics. To cite a few: Why has China been able to avoid a "transformational recession" (Kornai) and accompanying acute industrial dislocations?[2] Why has the transition been relatively smooth, albeit long? Why has the productivity of the state industrial sector been increasing steadily? Why has the non-state industrial sector expanded rapidly from the outset? Naughton's best contribution by far is the integrated explanation he offers for these central questions.

For Naughton, the ultimate paradox in China's reforms is that substantial ex-post coherence emerged from the reform process despite the fact that policymakers did not begin reforms with a blueprint, and subsequent efforts to introduce coordinated programs were unsuccessful. Gradualism, another characteristic of China's reforms, was also not by

[1] According to an estimate by Li Jingwen and his associates, the annual growth rate of total factor productivity rose to 2.5 per cent in the 1979–90 period from –0.8 per cent in the 1953–78 period, while the GNP annual growth rate increased to 8.4 from 5.9 per cent. See Li Jingwen, Dale W. Jorgenson, Zheng Youjing, and Masahiro Kuroda, *Shengchanlu yu zhong mei ri jingji zengzhang yanjiu* [Productivity and economic growth in China, United States, and Japan] (Beijing: Zhongguo-shehuikexue-chubanshe, 1993), p. 52.

[2] J. Kornai, "Transformational Recession: The Main Causes," *Journal of Comparative Economics*, Vol. 19, No. 1 (August 1994).

choice but an unintended result of the process in which "so much time was wasted pursuing dead ends and even regressive policies" (p. 22). Without a coordinated program, China's reforms have been inescapably path dependent, and many later successes can be traced back to the initial policies adopted. Naughton points out two such policies in the early period of reforms: (i) the relaxation of the state monopoly over industry in 1979, and (ii) the adoption of the "dual-track" approach in 1984. The former introduced competition into industry and the early success of reforms led to the launching of the latter.

The dual-track approach, the distinctive feature of China's economic reforms in Naughton's view, separates China's path from the European rationalizing reform under socialism (as in Hungary's 1969 reform towards market socialism) and the "big bang" reforms since 1989. In the dual-track approach, while part of economic activity remains planned and acts as an anchor, economic sectors exposed to the market are encouraged to grow and ultimately to dominate the economy. Absent here are elegant theories of market socialism and the clean break from the old system under the big bang. The dual-track approach is nevertheless equipped with an adequate guidance mechanism in which successive expansion of market-coordinated economic activity at each stage indicates the direction of reforms for the next stage.

Leaving aside introductory and concluding chapters, eight chapters in the book cover the economy immediately after the Cultural Revolution (1966–76) and three chronological phases of economic reforms (1979–83, 1984–88, and 1989–). The command economy in pre-reform China was, according to Naughton's review in Chapter 1, capable of channelling resources into the state sector by means of arbitrarily set terms of trade and state monopoly over the distribution network. Although the management of economic planning in China was weak and less effective than in the former Soviet Union, aggregate output grew continuously thanks to the mechanism for pumping the state's resources into new investment. However, public enterprises, which developed under state control and guidance, were organized with little regard to comparative advantage and eschewed much of the efficiency gains from specialization.

It was the initial response to the malaise of this system that set off a virtuous cycle of reforms, as well as allowed the Chinese economy to avoid the strains that beset Soviet reformers in the 1980s (Chapters 2 and 3). Once Chinese policymakers recognized the drawbacks associated with the command system in 1979, growth acceleration based on the ambitious ten-year economic program was discarded and policies to reorient economic development strategy began. The reform then was only an attempt to "improve the operation of the economic system, through whatever means seemed appropriate" (p. 99). Abandonment of growth acceleration, nevertheless, released resources to the consumer goods industry, lessened demand pressures in the market, and provided a favorable macroeconomic environment from which a new round of reforms could be launched.

According to Naughton, such positive reinforcement in the reform process was most pronounced following relaxation of the state monopoly over industry in 1979. Removal of barriers resulted in the entry on a large scale of non-state enterprises attracted by profits to be earned on high state-fixed prices of industrial consumer goods. Rural industry's explosive growth in this period was achieved by moving into the void left by the state sector. (Small enterprises had remained underdeveloped in fields where small enterprises had held a comparative advantage.) Massive entry exposed state enterprises to market competition, lowered their profitability, and consequently squeezed state revenues which depended heavily on profit transfers from state enterprises. To secure revenue sources, the government strengthened the monitoring of enterprises on the one hand and offered managerial incentives in the form of expanded autonomy on the other. The pressure to adapt to the new environment compelled state enterprises to improve performance, and their productivity began to rise quickly. Naughton states, “There are certain critical, or core, features of the command economy, and once those are eliminated or weakened, the system has a tendency to devolve into a different type of system” (p. 309). Policymakers gave up some of the core features at the early stage of the reform without due consideration, and the Chinese economy began to move away from the command system.

Despite a variety of piecemeal measures implemented in the first phase (1979–83), attempts to coordinate new policies into a coherent program failed. The main impediment was the inability, in the face of strong resistance, to correct the distorted price structure and to introduce new fiscal and financial arrangements. The delay in these areas of reforms left the government incapable of steering the economy with indirect tools, such as relative prices and tax and interest rates, in line with market socialist ideals. The breakthrough arrived when the reformers, led by Zhao Ziyang, introduced the dual-track approach as an alternative in 1984, marking the beginning of the second phase (1984–88). Under this approach, state enterprises were still mandated to fulfill their plans but the obligations were fixed at initial levels, leaving enterprises free to produce beyond plan quotas for sale in the market. Restrictions on the prices applied to above-plan output were abolished soon after and many state-fixed prices were adjusted successively in accordance with market prices. In 1987, moreover, enterprise managers were offered long-term profit contracts, and this put an end to annual bargaining between managers and supervisory divisions over the disposition of profits.

Naughton claims that the inner logic of the reform strategy in the second phase was “to expand market forces by limiting the scope of planning, fostering entry, and improving incentives and autonomy for state-run enterprises to operate on the market” (p. 200). Under the dual-track approach, fixed obligations and long-term profit contracts served as credible commitments by the government, and market prices began to guide enterprise behavior. The cumulative impact of new entry and market competition was most evident in the dramatic narrowing of the standard deviation of the rate of return on assets across different industrial sectors in the 1980s, from 19.7 per cent in 1980 to 7.4 per cent in 1989 (p. 237).

Although high inflation in 1988 ended the second phase of reforms, the setback, which began with a retrenchment designed to lower inflationary pressures, was temporary. The Communist Party Congress in October 1992 acknowledged belatedly that the ultimate goal of reforms was transition to a market economy. From that year to 1994, great progress was made in price decontrol and in introducing new economic laws. New tax and fiscal systems were launched and the foreign exchange rate was unified. By the end of the first half of the 1990s, the Chinese economy was on the verge of completing the process of gradual marketization that had begun in 1979, and was ready to shift reforms to establishing a well-functioning market economy (p. 302).

Naughton regards the Chinese dual-track approach as the third model of reform after those of the European rationalizing reform and the big bang reform. The main implication of this Chinese model is that transition to a market economy becomes a self-enforcing process once some of the core features of the command system are eliminated. Because the growth of market-based economic activity provides efficiency gains, puts strains on existing institutions, and highlights the areas where potential gains of reforms lie, policymakers have strong incentives to move ahead on the reform path. This is why, after the old system ceases to operate fully on its own, market forces grow by themselves. A corollary is that a comprehensive program, ex-ante coordination, or even consensus on the general goal among policymakers is not a prerequisite to successful transition. Indeed, many deviations from the first-best transition regime do not affect the end result. These imperfections instead consume extra time and additional resources associated with sub-optimal resource allocation during this time. In other words, the length of the transition process depends on the extent of imperfections in the reform strategy and implementation. China's experience, by Naughton's interpretation, indicates that gradual reform is feasible and may serve as a good alternative to the other two models. Above all, the dual-track approach does away with ex-ante coordination of the reform process under the European rationalizing reform and high short-run adjustment costs under the big bang reform.

This book is somewhat short on the dark side of China's reforms. A by-product of the gradualist reform has been the rise of rent-seeking activities. Widespread corruption and abuses associated with perverse incentives accompanying the dual-track approach and opportunistic behavior by local governments following the adoption of piecemeal empowerment measures are two subjects that merit more attention. Naughton points out the delays in institutional development as the major shortcoming of the reform process. The most pressing tasks are specifying property rights and assigning full accountability in the investment system (pp. 322–33). This reviewer, however, accepts the main arguments of the Chinese reform model and thinks that these drawbacks will not block China's path towards a well-functioning market economy. (Hiroyuki Imai)

Ecology and Practical Technology: Peasant Farming Systems in Thailand by Shigeharu Tanabe, Bangkok, White Lotus, 1994, xx + 300pp.

The purpose of the present book is to explain how the Thai rural population acts upon particular physical environments, and vice versa, from the perspectives of ecology and socioeconomic relations. Whenever attempting to analyze societies composed of people engaged in the occupation of agriculture, it is necessary to take into consideration the determinative nature of the surrounding physical environment, thus creating a set of assumptions not necessary in the study of, say, urban society. Conversely, assuming that agriculture is a socioeconomic activity, it follows that any study that does not discuss interaction between people and nature in relation to social conditions would be meaningless. The author, who is fully aware of the above two assumptions, uses the concept of "practical technology" in an