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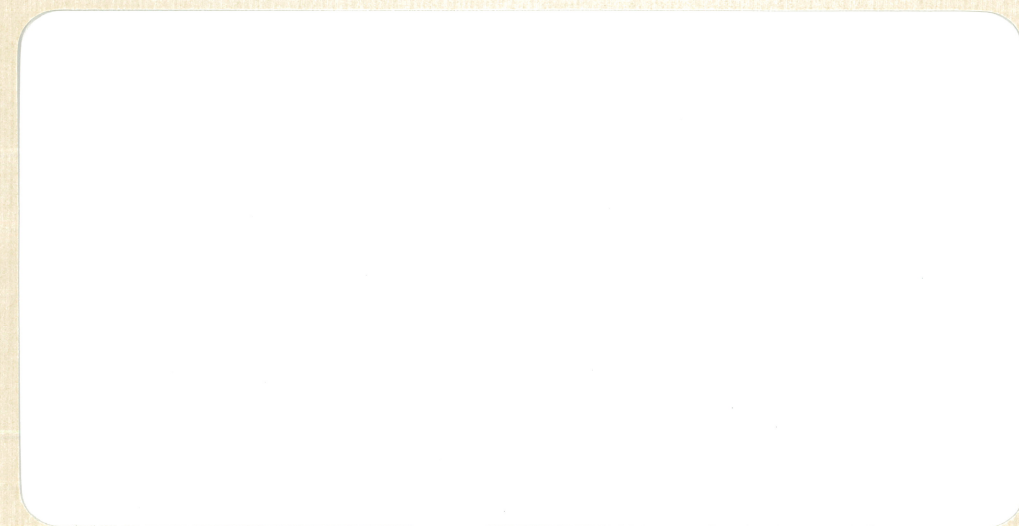
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from a Centrally Planned to a Market Economy**

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Challenges Faced in Transforming from a Centrally Planned to a Market Economy

By Tzong-shian Yu*

I. Introduction

A change in industrial structure stems mainly from the progress of technology, while a change in economic system comes basically from policymakers. The former can cause traditional industries to decline, while the latter can cause the existing economic system to become defunct. Since the late 1980s, many Eastern European countries and the former Soviet Union have taken radical measures to change their economic systems from centrally planned economies to market economies. So far they have suffered greatly from hyperinflation and serious unemployment without much positive achievement.

In contrast, mainland China began to adopt an open-door policy and economic reform measures more than 14 years ago and has realized remarkable achievement. This, in turn, has increased policymakers' confidence in transforming the economic system from

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a centrally planned economy to a market economy. Even though the change has been gradual, it has been dramatic in nature, and many problems have resulted. The purpose of this paper is to explore the challenges faced by mainland China in the transformation. In order to examine the challenges, we will first point out the difficulties in the transformation of an economic system and then analyze various challenges faced in the process of transformation and possible solutions which may be useful for policy makers.

II. Difficulties of Transforming an Economic System

The transformation of an economic system from centrally planned to market is not an easy job. The problem is that there is no historical example to follow.¹ Many Eastern European countries and the former Soviet Union have accepted western economists' suggestion to adopt "shock programs," meaning to privatize state-owned enterprises using radical measures.² In the Russian Federation the government adopted radical economic reforms which have resulted in negative economic growth, hyperinflation and an extremely rapid depreciation of the ruble in the last two years.³ So far, there is no sign that the Russian economy has improved. In Eastern Europe, many countries are still in trouble, some of them suffering from hyperinflation and high unemployment, some struggling with political instability or civil war. For them, the road to a market economy is obviously strewn with obstacles. Unfortunately, they don't seem to know how to clear

them away.

During the last fourteen years, mainland China has adopted an open-door policy and economic reform. Both have been gradual and careful, and can be described as a strategy of “crossing the river by carefully feeling stones under the water.”⁴ This strategy has made a great contribution to rapid economic growth and the improvement of living standards. One naturally wonders why mainland China has had such remarkable success in its economic development while the Eastern European countries and the Russian Federation have not. The answers are as follows: (1) Mainland China’s political situation is comparatively stable. This allows the government to smoothly carry out the program of economic reform. (2) Mainland China has other Chinese societies such as Hong Kong, Singapore and Taiwan to observe for useful lessons. Although not all the laws and regulations of other Chinese societies can be applied in mainland China, many of them, in revised form, can be used as blueprints. (3) The strategy itself of “crossing the river by carefully feeling stones under the water” works very well. (4) Many overseas Chinese have made large investments in mainland China. The mainland Chinese are thus able to learn management techniques and other skills which are very important to a country at the early stage of economic development. This doesn’t mean that this approach is perfect. Actually, in the process of transformation, there are still many challenges to overcome.

III. Challenges Faced in the Process of Transformation

When a country has used a particular economic system for long period time, the economic system becomes a way of life and an integral part of the culture. If the economic system is suddenly and completely changed, it has a significant impact on the way of life and social values. There is no doubt the transformation of the economic system from one which is centrally planned falls into this category. Once an economic system is changed, usually two opposing reactions take place: (1) some people support the change since they suppose that they can gain from the change, and (2) some people resist the change since they know they will lose their vested interests. The former back the change in economic system while the latter fight against it. In the process of economic transformation, many challenges are faced. The most important are explored below.

1. The rapid growth of private enterprises has resulted in a large income discrepancy between the employees of the government and private enterprises⁵

Government employees include government officials, military officials and soldiers, public school teachers and employees of government-run enterprises. The salary and wages they receive are rather low compared to private enterprise employees. Because of this situation, it has become fashionable for people from all walks of life to become interested in doing business in order to earn more. Therefore, professors open factories, consulting firms and restaurants, and military servicemen run businesses in tourism and

transportation, for example, so as to increase their income. How should one assess this behavior? In the short run, it may be helpful in reducing differences in income between the public and private sectors, while in the long run, it results in many flaws. Possible flaws include: (1) the decline of administrative efficiency since many government officials use only a portion of their office hours on their administrative job and cannot concentrate on public affairs; (2) an increase of corruption because, due to the difference in income between the public and private sectors, some officials may ask for extra pay for their services; and (3) seriously influencing the teaching and research of professors and student behavior.

Actually, it is a natural phenomenon in many countries to tend to have a large income differential in the early stage of development.⁶ The problem is how to reduce income inequality. As people become richer, the government should establish a reasonable income tax system which is based primarily on household income. The government can then make use of income tax to increase government employee salaries. To encourage people to pay income tax, the income tax rates should be simplified.

2. The decline of state-owned enterprises has gradually reduced economic centralization

Under a centrally planned economy, the central government has the power to collect and dispose of its revenue. Economic centralization is the necessary result. Since 1979 when the Beijing government began adopting economic reform measures, private

enterprises have rapidly increased, and state-owned enterprises have correspondingly tended to decrease. For instance, by 1992, of total output in the industrial sector, state-owned enterprises accounted for 53%, and other enterprises for 47% (of which 35% was from collective enterprises in villages and urban areas and the remaining 12% is attributed to private enterprises). Government-run shops accounted for 40% of total revenue of retail sales for the whole country, while privately-run shops made up 60%.⁷ Before 1980, the main source of central government revenue was the surplus provided by state-owned enterprises. Since 1980, however, when the principle of "self responsibility for profit and loss" for state-owned enterprises was adopted, the central government gradually lost the main supplier of its revenue because most of them have incurred losses. It has thus turned to the provinces for support. However, only the rich provinces with rapid economic growth have been able to provide additional revenue to the central government. Eventually, a strong trend toward economic decentralization began to develop.

The further development of decentralization is obviously not what the ruling party wants. However, no one can change the fact that a market economy is the goal of economic reform. What the government should do is balance centralization and decentralization through reform of the tax system. Which taxes should be levied by the central government and which by the local governments should be carefully thought out. The source of tax revenues should be well-assured, because the central government is still the appropriate level to undertake many matters which cannot be given to local

governments, such as national defense, foreign affairs and so on. It is important to keep in mind that the central government is no longer so powerful as it was in the past.

3. Unbalanced regional development may result in many socioeconomic problems

Balanced versus unbalanced development has been debated for a long time. However, no evidence indicates that it is wise to adopt a strategy of regionally balanced development for a large country. Mainland China is a huge country and capital is insufficient to carry out an overall plan for the development of the whole country at the same time. Therefore, it was correct for the Beijing government to start its economic development from the Southeastern coastal area, in Guangdong and Fujian provinces. Even within these two provinces, the central government selected only a few places as special economic zones, making it more convenient for the delivery of exports.⁸ Through rapid economic growth, the Southeastern coastal area has substantially improved on the one hand, but has produced many socioeconomic problems on the other. The most important problems include: (1) the cost of factors has increased more rapidly here than other areas in the last ten years, where, for example, wage rates have increased five to seven times, and (2) the area has become characterized by highly speculative activities, such as the fact that the price of real estate increased sharply and many people tried to make money by means of real estate transactions. Consequently, the price of real estate has skyrocketed in the last three years.⁹

These two problems are damaging to further economic growth since it harms the

comparative advantages. Some evidence shows that many labor-intensive industries have already moved to foreign countries such as Vietnam. To solve the first problem, an open-door market economy not only for the coastal area but also for the inland area should be adopted, and to solve the second problem, lend-lease regulations need to be changed.¹⁰

To correct unbalanced economic growth, the time has come to open the inland area for foreign investment, and to attract foreign investment, the requirement that all products must be exported should be discarded and transportation facilities enhanced. If the interior is opened to foreign investment as well as to domestic investment, investors will relocate from the coastal areas inland, creating more job opportunities there and thus improving the standard of living. The wage levels in the coastal areas will then either remain stable or increase slightly.

4. Not all state-owned enterprises should be privatized

In a market economy, free competition tests whether a firm should exist or not. State-owned enterprises usually are weak in competitiveness because they are subject to many regulations and official intervention. Thus, they are inflexible in coping with rapid changes in socioeconomic conditions and often misjudge transaction timing. This is why many people insist that state-owned enterprises should be privatized. Privatization is not easy to accomplish, however. In view of the experiences of Eastern Europe and the Russian Federation, we can conclude that privatization cannot be achieved overnight.

Actually, in the early stage of economic development, some service industries

continue to require government management. If the price of public services is not determined by market forces but by the national assembly or a committee, private enterprises will be unwilling to enter that activity. For instance, the subway and bus fares in many countries are not set by the subway or bus company. In other words, private companies cannot increase their fares as they see fit, since fares are closely related to the public interest. Often, governments charge relatively low prices for their services in order to subsidize low-income citizens.

Before some state-owned enterprises are privatized, they should be made autonomous and independent of the direct intervention of the government in order to reduce the waste of resources and increase efficiency. Their activities should be supervised by the board of trustees (or directors), however.

5. Inflation is an inevitable phenomenon when a country transforms from a centrally planned to a market economy

It seems to be an inevitable consequence that high inflation will be experienced when a country transforms from a centrally planned to a market economy. In the last five years, Eastern European countries and the Russian Federation have suffered from hyperinflation. The impact of the drastic change in the price system is one reason. In a centrally planned economy, all prices are set by the government rather than by market forces. In order to adjust insufficient supply to meet necessary demand, a rationing system is generally applied. People have no freedom to choose once the price system is broken down, and

it takes a long time to achieve prices which are determined by market forces. In the process of adjustment, high inflation is predictable. A second reason is the influence of transport difficulties and the regional blockage of commodities. In many areas, a modern transportation system has not yet been developed. Regional regulations have also impeded the free flow of commodities. Most important, though, is that the central government has lost its power to collect and then distribute commodities to people who need them.

In the mainland, though inflation is not so serious as in other countries with centrally planned economies, many people are worried about inflation since it is much higher than it was fifteen years ago. Recent inflation originates from three factors. First, the price of real estate has risen sharply because of highly speculative activities, which, in turn, deteriorates the standard of living and increases the cost of production. Second, excess investment has occurred in many areas and there is an insufficient supply of materials to support production. And third, the People's Bank of China issues too much money in order to fuel regional development.

Recently, the People's Bank of China has adopted a tight-money policy which has been effective in reducing high inflation. However, it is not enough to use monetary policy alone. So-called "excess investment," meaning too much investment, is made in some coastal areas. This must be tackled. If investment in the interior is encouraged and the transportation system improved as quickly as possible, inflation can be reduced.

IV. Concluding Remarks

To sum up, the transformation from a centrally planned to a market economy is a dramatic change. Generally speaking, there are two types of change, one is radical and is called “shock therapy.” The other is gradual and step by step. The former doesn’t work as well as expected while the latter has resulted in remarkable achievements in mainland China. Even so, mainland China has still encountered many challenges which are complicated and involve institutional factors.

To deal with the challenges, the government should remain committed to the market economy. Only in a market economy can all resources be effectively employed, and efficiency accordingly strengthened. State-owned enterprises, if necessary, should be gradually privatized with sustained economic growth. Only if a country is able to maintain rapid economic growth allowing the private sector to grow strong can privatization be naturally achieved. A reasonable and effective tax system should be established in order to ensure revenues to both the local and central governments. To correct regionally unbalanced development, it is a wise policy to allow foreigners to make investments in the interior. Once the investment climate is favorable, it will be possible to reduce labor mobility from the north to the south and from the inland areas to the coastal areas and to equalize the wage level in different areas. Inflation is an inevitable phenomenon, but can be reduced to some extent if the money supply can be controlled. The transportation

system should be improved and intraregional blockages eliminated. In these areas, the government needs to play an active role.

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Notes

1. There are many examples of transformation of an economic system from a market to a planned economy. All of them used revolutionary measures to nationalize private property regardless of the public's reaction.
2. Professors J. Sachs and Milton Friedman hold this opinion. In Chinese, it is also called "shock therapy."
3. According to Plan Econ. Report (Dec. 9, 1992), in the Russian Federation, the growth rate of GNP was -13% in 1991 and -20% in 1992, and the inflation rate was 100% in 1991 and 2000% in 1992.
4. This is an old Chinese saying which is popular in Chinese societies. Since one does not know how deep the river is, when crossing the river, the best way is to carefully feel the stones under the water and move step by step in order to avoid risk.
5. Including household-owned businesses, village-owned businesses and joint venture businesses.
6. According to Simon Kuznets' study based on cross-country cross sections, there is an inverse U-shaped relationship between growth and equity, which means that as income increases from low levels in a developing society, the distribution of income must first worsen before it can improve.
7. Refer to Shang-chun Kao's, "A Gradual Approach Towards a Market Economy" (in Chinese), International Symposium on the Theoretical and Practical Issues of the Transition Towards the Market Economy in China, July 1-3, 1993.
8. In the early 1980s, the Beijing government first set up four special economic zones at Shenzhen, Zhuhai, and Shantou in Guangdong Province, and at Xiamen in Fujian Province. Later, Hainan Island was added and the Pudong investment zone created in Shanghai.
9. Since 1987, some businessmen from Taiwan and Hong Kong acquired much land at very low rent from local governments in the mainland, and then sold the lending right to other persons at high prices. After several turnovers, the price of land became very high. Recently, many local businessmen have also engaged in the same business through special channels and made big money.

10. Perhaps the Chinese government in the mainland never imagined that people would make use of lended land to make money, but in fact, they did. To eliminate speculative activities in land, private transfer for lended land should not be allowed. If the tenant must transfer lended land, he should transfer it to the land owner at a reasonable guaranteed price.

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