

# From Accelerated Accumulation to Socialist Market Economy in China

## Economic Discourse and Development from 1953 to the Present

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# From Accelerated Accumulation to Socialist Market Economy in China

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# From Accelerated Accumulation to Socialist Market Economy in China

*Economic Discourse and Development from  
1953 to the Present*

*By*

Kjeld Erik Brødsgaard and Koen Rutten



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# Preface

The purpose of this project is to provide new insight into the ongoing structural transformation of the Chinese economic system and concomitant economic developments by examining the role of economic ideas and discourse. The origins of this project date back to the early 1980s. In 1983, Kjeld Erik Brødsgaard, then a doctoral student at the University of Copenhagen, published a two-part article in the journal of *Modern China*, which comprehensively described the joint development of Chinese economic discourse and the economic system from the implementation of the First Five Year Plan in 1953 until the early years of reform in 1981. In his Ph.D. dissertation from 1989 entitled “Readjustment and Reform in the Chinese Economy 1953–1986” he took the analysis to the year 1986. Pervasive interest in the drivers of China’s remarkable economic transformation, and growing attention to the role of discourse in shaping the development of economic systems, made this an opportune time to reinitiate the project that Professor Brødsgaard commenced some 30 years ago. This book builds on his initial findings and extends them to present times. The analysis first presented in *Modern China* provides the basis for the first chapter and most of the second chapter, and informs the general approach taken within this study. In collaboration with Professor Brødsgaard, Dr. Koen Rutten has sought to supplement the analysis by introducing concepts from recent institutional theory and examining the joint development of economy and discourse in the last two decades. Kjeld Erik Brødsgaard has added a chapter on Xi Jinping, thereby bringing the analysis up to the present time. We hope the result will inspire new appreciation of the role of economic discourse in the ongoing project of Chinese economic development that started some seven decades ago.

The authors gratefully acknowledge the financial support provided by the EAC Foundation, without which this project would have been impossible. We also wish to express our gratitude to the Department of Economics and Management at Copenhagen Business School for hosting the project and to the Universities Service Centre, Hong Kong, for providing access to the center’s unique collection of material on China’s economic development. We also duly recognize the efforts of Xinru Zhang who assisted in preparing the manuscript for publication. Additionally, we would like to thank Nis Grunberg, Mart Platje and especially Robert F. Ash for insightful and encouraging comments on early drafts. Finally, Koen Rutten would like to express his gratitude to his wife Lin Lei, whose unconditional support has been significant for the completion of this project.

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## Introduction

China's trajectory of economic development has been remarkable in more ways than one. From 1978—the year in which China's leadership resolved to break away from the principles of the command economy—to 2012, gross domestic product (GDP) grew more than twentyfold, from 364.5 billion to 51.63 trillion yuan (NBS 2013, table 2-1). In that same period, average per capita GDP in constant units increased from 381 to 38,420 yuan, putting China squarely in the contingent of upper middle-income countries. This economic rise has had implications which far transcend national boundaries. In 2009 China became the world's largest exporter, a distinction accompanied by its status of the world's largest economy by the end of 2014.<sup>1</sup>

As such, China's economic development has become of pertinent interest not only to area specialists but to researchers and policymakers the world over. However, recent studies of Chinese economic development have generally paid but little attention to the role of economic discourse.<sup>2</sup> The speeches and writings of China's Party-state leaders and prominent economists (who often hold key positions in government's policy organs and think-tanks) constituted a major subject of earlier analyses (e.g. Schran 1962; Brødsgaard 1983b; Hsu 1985). Emphasis on the study of discourse subsequently disappeared as China's borders opened up to foreign researchers and the Chinese government began the compilation and publication of detailed statistics. The shift away from the study of indigenous discourse has been accompanied by a perceived decline of the stature of Maoist–Leninist ideology (Misra 1998). The pragmatic approach to economic governance adopted by post-Mao leadership (Deans 2004) has contributed to a common perception that the extensive repertoire of indigenous slogans and theoretical constructs serve little purpose other than maintaining a veneer of legitimacy for one-Party administration of China's political apparatus and economic system.

Yet discourse is central to economic governance.<sup>3</sup> Governance sets the institutional conditions for the organization of capital, labor and competition,

1 By purchasing power parity (PPP), <<http://www.imf.org>>.

2 For an exception, see for example Wang (2011); Hsu (1989); Holbig (2001). The most recent example of an “ideational approach” to China's political economy is Eaton (2016).

3 Hall (1993) proposes a three-tier hierarchical model of policy; paradigms, which define the overall economic objectives and basic causal explanations of economic phenomena;

and encourages certain types of economic activity and actors while inhibiting or delegitimizing others. Therefore, we seek to contribute to the extant literature on Chinese economic development through an in-depth study of Chinese economic discourse and its relation to governance.<sup>4</sup> Our analysis of Chinese economic governance is informed in particular by the concept of economic paradigms, the narratives which inform elite understandings of the nature and working of the economic system and, as such, provide the substance for economic programs and policies. Such narratives have two functions. They are interpretative frameworks, allowing actors to formulate causal explanations about economic phenomena. In addition to allowing for sense-making, narratives play an indispensable part in politicking. Factions compete for influence by way of advancing narratives that discredit or negate contesting ideologies (Hall 1993; Schmidt 2008). In fact, as we shall discuss in more detail in a subsequent section, sensemaking and politicking are intimately interlinked. When dominant narratives fail to provide efficacious answers to economic problems they lose their credulity and legitimacy, thus opening up a discursive space for rival factions to advance alternative interpretations.

In the following chapters, we trace how economic ideas emerged, changed or became obsolete and were superseded as China's leadership sought to drive forward the grand project of economic development and deal with its attendant problems. This is thus not an analysis of Chinese economic growth per se. We do not seek to deal extensively with the quantity of growth and its constituent elements (i.e. the relative contributions of labor, capital and factor productivity). Nor do we purport to provide a comprehensive analysis or explanation of the evolution of the Chinese economy. However, the study of economic paradigms allows us to ask certain questions that are difficult to answer without taking into account the reciprocal dynamic between discourse and economic phenomena or the actual substance of elite economics. We focus in particular on two of these.

First, we ask why the Chinese economic system has developed by way of a periodic succession of distinct and sometimes contradictory modes of governance. This matters because in China we have witnessed large and discontinuous changes in the roles of market and state, private and public

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techniques, that is, the fiscal, monetary and regulatory arrangements by which the state seeks to achieve its objectives; and policy settings, the ratios, severity or leniency maintained in applying those techniques.

- 4 Our corpus of economic discourse encompasses two main sources: academic texts derived from leading economic journals, the prominent publication *Jingji Yanjiu* (economic research) in particular, and the speeches and writings of central Party-state leaders as well as national economic plans.

enterprise and the rural and urban economy, which are not easily explained by extant theory. Nor does the fashion in which these periodic transformations occurred suggest any clear predetermined strategy or correspond to any articulated blueprint—Marxist or otherwise—for economic development. Second, we ask why the continuous and rapid accumulation of fixed assets has been a persistent focal point of governance. For over three decades now, government has intensely debated the need to transition from a model of growth based on the continuous expansion of industry to one driven by technological advancements and domestic consumption. Yet, somewhat perplexingly, reliance on investment in fixed assets has only increased in recent years. Both these issues seem to refute that economic governance, or economic paradigms themselves for that matter, are simply outcomes of rational deliberation and action on the part of the state. Rather, we interpret the haphazard changes and inherent contradictions within Chinese economic paradigms and governance as result of a reciprocal dynamic between discourse, politics and economic outcomes. However, before we preview our answers to the foregoing questions, we briefly survey the overall contours of economic development between 1953 (the year in which the Chinese Communist Party (CCP) introduced the first of its Five Year Plans) and 2012; the focus here is on change in the dynamics of growth (which, as we shall expound subsequently, were correlated with shifts in the mode of governance) and the continuity of rapid accumulation. We then introduce the main theoretical interpretations of the drivers of the transformation of China's economic system and present some thoughts on their respective merits and weaknesses. Finally, we discuss our analytic approach and its application to the issues of change and continuity in Chinese economic governance.

### **Changes and Continuities in Chinese Development (1953–Present)**

As stated previously, this book does not aim to quantify Chinese economic growth or its constituent elements and drivers.<sup>5</sup> Rather, we are interested in the process whereby the economic paradigms that dominate politics shape governance, and how these paradigms and their attendant modes of governance are, in turn, adjusted or supplanted when challenged by economic outcomes or shifts of political influence. Nevertheless, to understand the reciprocal relation between discourse and economics, it is necessary to refer at times to the general dynamics and qualities of growth. Here we focus on two elements which are

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5 Those interested in such quantitative analyses can consult Brandt and Rawski (2008); Young (2003) and Ostry (2009) amongst others.



central to Chinese economic discourse and therefore of particular importance to our analysis: the relationship between investment and consumption (which jointly make up GDP from an expenditure perspective), and the sectoral composition of the Chinese economy.

In China's seven or so decades of economic development under the rule of the CCP, we can distinguish three distinct patterns of development, corresponding to three equally distinct modes of governance: (1) 1953–1978: accelerated industrialization under central planning; (2) 1978–1992: rapid development of rural industry under decentralization and partial market relations; (3) 1994–2012: the reestablishment of central control over investment through the application of “economic levers.”

A cursory examination of the growth rates of gross fixed capital—a measure of additions in productive assets such as buildings, machinery and improvements to land—and household consumption, demonstrated this difference in the patterns of development in the Maoist and reform eras (see Figure 1). Under Mao, the Chinese economy experienced significant but highly volatile growth. This growth was accompanied by massive surges in the formation of gross fixed capital, followed by precipitous drops. High rates of capital formation were sustained by maintaining increases in consumption expenditure below the rate of growth of GDP (Figure 2). As a result, industry's share of GDP rapidly increased from 25.9 percent during the First Five Year Plan to 43.2 by the end of the Fourth Five Year Plan in 1975. Due to a strategy of expropriating agricultural surplus for the benefit of the expansion of heavy industry, agriculture's share of output dropped commensurately (see Table 1).

In comparison, from the introduction of reforms onward, the Chinese economy experienced more stable growth, and consumption expenditure developed at a higher rate, albeit still lower than that of investment. In fact, in the immediate years after the introduction of reforms (1978), the growth of consumption expenditure initially outpaced that of the overall economy, and in certain intervals even surpassed the growth of gross fixed capital formation (GFCF) (Figure 2). This increase in consumption expenditure was brought about by a rapid upsurge of growth in the labor-intensive agricultural sector and service industry under the Sixth and Seventh Five Year Plans respectively. However, during the first two decades of reform, the economy continued to experience pronounced conjunctural movement as massive local investment in rural light industry and services led to overcapacity and inflation. This overheating of the economy was controlled by extensive central fiscal measures, which, however, invariably inhibited growth. But, from the mid-1990s onward, the growth of consumption expenditure has been much more modest and the Chinese economy has reverted to a model of growth characterized by centrally

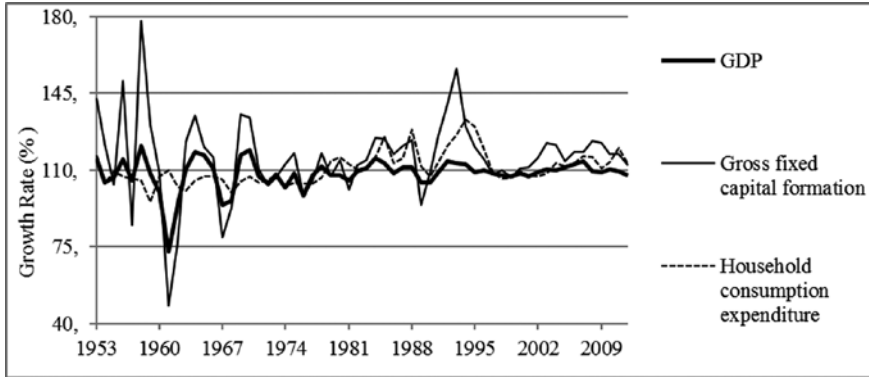


FIGURE 1 *Growth rate of GDP (%), household consumption expenditure (HCE) and gross fixed capital formation (GFCF), 1953–2011.*

SOURCES: CHINA STATISTICAL PRESS (2005, TABLE 10), NBS (2013, TABLE 2-17).

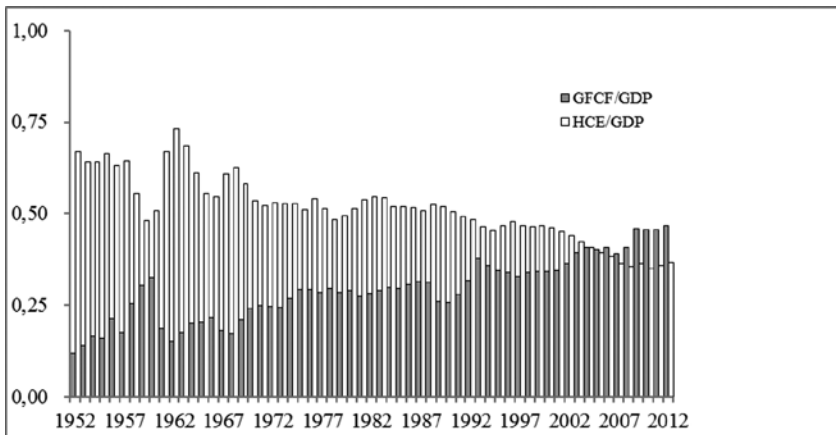


FIGURE 2 *GFCF and HCE as proportion of total GDP (%), 1952–2012.*

SOURCES: CHINA STATISTICAL PRESS (2005, TABLE 10), NBS (2012, TABLE 2-17).

directed investments in fixed capital both in industry and real estate. In this period both overall growth and fixed capital formation have developed in steadier fashion.

Notwithstanding changes in the pattern of formation of fixed capital and its sectoral distribution, high accumulation has been a persistent feature of Chinese economic development. As shown in Figure 2, the share of GFCF in

overall GDP consistently increased, rising from an average 21.8 percent in the communist era to 34.5 percent in the period of reform,<sup>6</sup> and reaching an unprecedented height of 46.6 percent in 2012. This trend has been mirrored by a commensurate decline in the share of consumption expenditure. In sum, Chinese economic growth has been characterized by periodic changes in the dynamics of accumulation, from “big pushes” in investment during the Maoist era, to bust-and-boom-type growth in the initial period of reform and more stable, investment-driven growth from 1994 onward. Despite these changes, the ratio of GFCF to GDP has consistently increased, a development driven predominantly by the expansion of capital-intensive industry.

### Explanations of Change within Chinese Economic Governance

The idiosyncratic transformation from centrally planned system to the present admixture of state coordination and market exchange has been a central

TABLE 1 *Sectoral composition of GDP, 1953–2012 (%)*

Plan	Period	Primary	Secondary	# Industry	# Construction	Tertiary
1st	1953–57	44.6	25.9	21.9	4.0	29.5
2nd	1958–62	32.2	37.4	33.2	4.2	30.3
	1963–65	39.2	34.4	31.0	3.4	26.4
3rd	1966–70	38.8	35.7	32.5	3.2	25.4
4th	1971–75	33.5	43.2	39.3	3.9	23.4
5th	1976–80	30.4	47.0	43.0	4.1	22.5
6th	1981–85	31.8	44.2	39.9	4.4	23.9
7th	1986–90	26.4	43.0	38.0	5.1	30.6
8th	1991–95	21.2	45.1	39.4	5.7	33.7
9th	1996–2000	17.4	46.6	40.7	5.9	36.0
10th	2001–05	13.3	46.0	40.5	5.5	40.7
11th	2006–10	10.8	47.7	41.7	6.0	41.4
12th	2011–12	10.1	46.0	39.2	6.8	44.0

SOURCES: NBS (2009, TABLE 1-7; 2013, TABLE 2-5).

6 Data for 1952 (the first year for which data is available) to 1977.

fixture of analysis. A large number of studies have examined the dynamics of Chinese growth through analysis of the changes in productivity of capital, labor and technology with regard to economic growth (Young 2003; Brandt and Rawski 2008; Ostry 2009). Other research has focused less on growth per se and instead emphasized economic organization, such as the roles of state and market (Tsai 2007; Huang 2008; Chu 2010), the institutional legacy of socialism (McNally 2007; Lin 2011), and economic and social outcomes (Chang 2003; Hu, Oppen and Wong 2006). In explaining the driving forces behind the ongoing reconfiguration of modes of governance, studies have generally adhered to one of two views.

Efficiency-based explanations (Naughton 1996; Hart-Landsberg and Burkett 2004; Szelényi 2010) emphasize how institutional change is prompted and directed by pressures to optimize the organization of production and resource allocation so as to maximize profits and minimize waste. Convergence theory (Buckingham 1958; Galbraith 2007), which predominated in Western economic thinking in the 1960s and 1970s, held that the profit incentive and market exchange best served the objective of efficiency maximization. This, it was believed, would impel a gradual global tendency toward the system of market capitalism. Although convergence theory was subsequently criticized for its functionalistic orientation and insensitivity to path dependence (Skinner 1976), neoclassical assumptions about the formative influence of the principle of efficiency on economic systems have persisted in the guise of transition economics, which study the transformation from socialism to capitalism. Applications of the transition paradigm to the case of Chinese economic development emphasized how much the progressive adoption of market reforms owed to self-reinforcing market dynamics and interdependence between economic institutions. Naughton (1996) described how scarcity of consumption goods—a consequence of the unrelenting emphasis within the command economy on the expansion of heavy industry—impelled rapid entry into light industry and market expansion following the introduction of private production in the late 1970s. The development of non-public producers in turn exerted competitive pressures on state-owned enterprises (SOEs), promoting corporatization and price rationalization (Lardy 2014). Meanwhile, increases in household savings provided additional investment for the market economy, allowing for its continuous expansion. In this manner, the Chinese economy gradually “grew out of the plan,” and direct state coordination of production and exchange played an increasingly smaller role.

Implicit in this dynamic process is a refined conceptualization of the convergence tendency, emphasizing the interdependence of economic institutions. Recent comparative studies of economic systems generally assume that

the institutions (i.e. rules and regulations; see North 1990) regulating key relations (e.g. those between investment and consumption, capital and labor) and processes (e.g. the organization of the financial regime, industrial relations, interaction between producers) within economies will affect one another in ways that either complement each another or give rise to systemic antagonisms and imbalance (Aoki 2001; Hall and Soskice 2001). Hart-Landsberg and Burkett (2004) describe how partial decentralization of production and exchange brought about differential prices within the public and private economy, which prompted extensive arbitrage by SOE. Moreover, the government's continued responsibility for enterprise losses induced massive unproductive investment by public enterprise. Such adverse economic behavior necessitated subsequent price reform and adjustments to the governance of public enterprise. The process described by Hart-Landsberg and Burkett, wherein institutional changes in one sphere of the economy cause imbalances that give rise to a need for adjustments in contiguous institutions, underscores the assertion that socialism and capitalism comprise cohesive and distinct modes of economic organization and their constitutive elements are not simply interchangeable (Szelényi 2010). Such explanations of the development of China's economic system avoid convergence theory's presumptions regarding the unchallenged superiority of liberal capitalism. They nevertheless imply that, once market relations are introduced within socialist systems, pressures for efficiency will push for further reforms.

The second explanation of the ongoing transformation of the Chinese economic system focuses not on the technical constraints of interdependent forms of organization, but rather on dynamics within the political sphere. Although the CCP has retained a monopoly on political authority, the distribution of political power *within* the state is in fact highly dispersed and ambiguous.<sup>7</sup> This "fragmented authoritarianism," which would come to dictate policy-making after the introduction of reforms in 1978 (Lieberthal and Oksenberg 1988), originated in the early years of the People's Republic. The dispersion of political authority across a large number of bureaus was partially motivated by Mao's reservations about the development of a strong central bureaucracy that could potentially undermine the primacy of Party rule (Lieberthal

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7 The Party maintains this monopoly due to the absence of popular suffrage and a governance structure wherein administrators at each level of the state bureaucracy are subject to supervision by the CCP's Organization Department (*zuzhibu*) at the next higher level, which manages the appointment, promotion and dismissal of China's leaders (Burns 1994; Brødsgaard 2002). Although additional political parties exist, their status is purely consultative and, as such, they cannot exert direct influence over policy.

1997). Additionally, Party leadership perceived a need to ensure that the state bureaucracy would prove responsive to varying local conditions (Lieberthal and Oksenberg 1988; Lyons 1990). This resulted in the rather unique administrative system of *tiao-kuai* (lit. “lines and blocks”). Under this arrangement, which persists to the present day (2016), bureaucratic organizations either fall within the functional (*tiao*) or regional (*kuai*) category. The former ensures that central policies are devolved to and implemented by lower levels of the administration, while the latter allows for adjustments, if warranted by local conditions and desired by local Party and state organs.

The idiosyncratic structure of the Chinese state gave rise to two related indigenous conceptualizations of institutional change. A first explanation emphasized how reforms under Deng Xiaoping intensified political fragmentation. The devolution of fiscal authority to the provinces in the initial stages of reform had weakened central control. At the same time, the *tiaokuai* system prohibited the articulation of spheres of responsibility and authority. This, argued Shirk (1990; 1993) resulted in a process of policy formulation characterized by protracted bargaining between subcentral bureaucratic constituents. The role of the central state was chiefly confined to the selection of bureaucratic contenders within the policy arena and mediation between actors,<sup>8</sup> should they fail to reach consensus. Because of the limited direct involvement of the center in economic policymaking, and the emphasis on consensus, outcomes tended to reflect the vested interest of subcentral bureaucracy.

Whereas the bargaining approach aptly describes the quality of policymaking throughout the 1980s and early 1990s (Lampton 1987), the subsequent shift in the distribution of power from locality to center considerably reduced the scope for such bargaining. More recent explanations in the vein of the fragmented authoritarianism framework consequently put greater emphasis on the role of consensus building at the apex of the state apparatus. Provincial government is considered to assert its influence predominantly through policy experimentation. Although the consolidation of political control within the center has restrained local deviation from national regulations, the lion’s share of routine economic governance falls outside of the remit of the central state. This provides local government with considerable leeway to engage in the formulation and implementation of novel policy initiatives. Moreover, because local administrators’ professional advancement primarily depends

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8 A primary means by which the central state shaped arenas for policymaking was through the establishment of so-called leading groups (*lingdao xiaozu*)—ad hoc organizations of leaders of relevant bureaucratic organs, chaired by a prominent member of the central state—formed specifically around pressing policy issues (Brødsgaard 2002; Pearson 2007).

on regional economic performance, a strong incentive exists for these local administrators to formulate policies that expedite economic growth (Xu 2011). Because the implications of such policy entrepreneurship are limited to the locality, experiments provide a low-risk means of assessing the efficacy of experimental measures (Qian, Roland, and Xu 2006). Successful trial implementation may convince central leadership to elevate such policies to the level of national policy. Consequently, more recent fragmented authoritarianism approaches consider local policy experimentation the primary driver of institutional change (Heilmann 2008; Xu 2011).

The efficiency and fragmented authoritarianism perspectives each provide important insights into the nature and dynamics of Chinese economic development. Emphasis on the interdependence of economic relations and processes draws attention to the manner in which unanticipated imbalances within the economic system, resulting from incompatible institutions, provide an endogenous drive for further institutional change. Moreover, such a perspective suggests that the nature of emerging imbalances and subsequent institutional adjustments depend on the manner in which established and new forms of economic regulation interact with one another. The fragmented authoritarianism approach demonstrates that economic governance is not merely a process of technical optimization, but is shaped by political dynamics. Within China's layered and disjointed state apparatus, local policy experimentation and central consensus building exert opposing forces for transformation and stabilization on the trajectory of economic development.

Nevertheless, several important issues remain. First, by focusing on the roles of market institutions and decentralized bargaining and experimentation, conventional explanations are biased toward the post-Mao era. Such an approach may seem justified when adhering to the conventional evaluation of China's economic development, which contrasts institutional dynamism and rapid growth in the post-Mao period with sluggish growth under a monolithic socialist system of central economic administration. Nevertheless, from its establishment in 1949 until the introduction of reforms in 1978, the coordination of socialist planned economy went through several distinct phases, characterized by considerable differences in the roles of bureaucratic administration and central planning. Moreover, as we will discuss subsequently, Maoist-era economics and policies would continue to exert great influence on subsequent discourse and governance (Hung 2016).

Second, although the quality of institutional arrangements may determine the character of economic problems that appear at any specific point, they do not prefigure the measures advanced by actors to deal with them. Rather, the

formulation of responses to economic problems is a cognitive process, based on the varying conceptions of actors regarding the main components of the economic system, the interrelations between them and resultant outcomes. To complicate matters, these actors may hold divergent views as to the objectives of economic organization. Contrary to neoclassical assumptions about agents' single-minded pursuit of utility maximization, policymakers' pursuit of economic efficiency is generally moderated by concerns relating to, for example, distributive issues, national competitiveness and security, and short- versus long-term tradeoffs. Due to the multiplicity of (sometimes incompatible) objectives, decision-making is likely to take the shape of satisficing rather than rational optimization (Simon 1962).<sup>9</sup> The problem of the ostensibly indeterminate nature of decision-making is compounded when we consider the role of politics stressed by the fragmented authoritarianism approach. If policymakers seek to not only simultaneously advance multiple objectives, but seek to do so in ways that are most beneficial to their respective bureaucratic constituency, then how can they arrive at the consensus necessary to realize coherent policy programs?

Finally, efficiency- and fragmented authoritarianism-based perspectives are unable to adequately capture the dynamics of change within economic governance. The notion of convergence implies that the underlying logic of market capitalism will result in a teleological process of institutional transformation. However, as Peck and Zhang (2013) note, the development of the Chinese economic system has not developed in unitary fashion, but has rather been characterized by periodic non-linear alternations and contradictions. Fragmented authoritarianism's emphasis on the roles of vested political interests and local policy experimentation may prove a better fit for such a dynamic, but it likewise suggests that change in governance will be predominantly incremental. Nevertheless, processes of gradual transformation have been accompanied by periodic comprehensive reorganization. Such changes can hardly be explained by a focus on the disparate initiatives of separate bureaucratic actors. We believe that an emphasis on economic discourse can enrich the fragmented authoritarianism approach by stressing that policymaking is not only a result of the interaction of bureaucratic actors, but that policy platforms also play a role.

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9 Satisficing refers to a strategy of decision-making where a solution is deemed acceptable if it meets actors' threshold values for stipulated criteria.



## Discourse, Economic Paradigms and Governance

In contrast to analyses revolving around the technical constraints of market coordination or political configurations, this study of the Chinese economy focuses on the manner in which discourse shapes and constrains policy-making. Discourse is “language as a form of social practice” (Fairclough 1989, p. 22). Such a definition, while admittedly very broad, nevertheless suggests several relevant aspects. First, language is a product of social interaction and convention, and thus structures the manner in which ideas can be formed and expressed. Conversely, contention about the meaning of linguistic concepts (such as “socialism,” “capitalism,” “efficiency” and “equality”) can have profound implications for patterns of action. Second, the quality of discourse depends on its social setting. What expressions, concepts and propositions are deemed appropriate and who has a right to participate in discourse are determined by institutionalized principles of interaction. Discourse in turn is instrumental in sustaining these social principles by allowing for the continuous replication of established concepts and modes of interaction. Discourse thus is inherently political (Van Dijk 1989).

According to “discursive institutionalism” (Schmidt 2008), the reciprocal relationship between political language and institutions is a crucial determinant of the setup of economic systems. One of the earliest comprehensive analyses of the influence of discourse was provided by Van der Pijl ([1984] 2012), who studied how the economic programs of the Roosevelt and Kennedy administrations, and the Marshall Plan, promoted a transatlantic union of industrialists, investors and labor. The covenant between these constituents was made possible through an underlying ideology of corporate liberalism, characterized by the free international flow of capital and the institutionalization of the interests of industry and labor at the level of the nation-state. In similar vein, Hall (1993) examined how the emergence of monetarism provided the ideological underpinnings for the neoliberalism of the Thatcher administration, prompting a marked departure from the interventionist orientation of initial Conservative policies. Economic paradigms are thus instrumental in coordination across actors and constituents. Schmidt (2008; 2009) explains how actors articulate and organize around their respective interests by developing competing narratives. However, in order to be perceived as acceptable, such narratives also need to address the concerns and respective positions of other parties. As such, these narratives constitute a primary means by which constituents seek to compete and bargain with other policy actors.

In addition, discourse enables actors to develop cognitive and normative frameworks that allow them to interpret developments and emerging

phenomena within the economy and formulate appropriate responses. According to Hall, “policymakers customarily work within a framework of ideas and standards that specifies not only the goals of policy and the kinds of instruments that can be used to attain them, but also the very nature of the problems they are meant to be addressing” (1993, p. 279). Generally, these overriding objectives and causal explanations provide the implicit foundation for, but do not directly factor into, routine decision-making. However, unanticipated antagonisms or destabilizing dynamics (of the sort emphasized by the efficiency-based perspective) may cause established norms and assumptions to be called into question. Persistent failure to provide explanations for, or responses to, systemic problems—for example when Keynesianism was unable to account for the rampant stagflation in the UK in the late 1970s—prompts paradigmatic crisis and creates scope for the development and promotion of alternative narratives. In such instances, what paradigm will emerge as dominant depends both on its explanatory merit as well as the distribution of political influence, as powerful constituents will be able to marshal greater resources to promote their associated narratives.

### **A Discursive Explanation of Change and Continuity in China’s Mode of Governance**

On basis of the foregoing, we can begin to outline the general features of a discursive approach to the study of economic governance, and formulate tentative explanations to our questions regarding the quality of change. According to this perspective, the establishment of a mode of governance is prefigured by the articulation of an economic paradigm, a general framework describing elite beliefs about the causal mechanisms operating within the economic system as well its general objectives. Over time stochastic variations and structural juxtapositions within the economy, however, tend to lead to (undesirable) outcomes that are unaccounted for by this paradigm. This discrepancy between established beliefs and actual outcomes will exert pressure for a reevaluation of established notions about the working of the economy. If economic problems are grave enough, political conditions are amenable to change and alternative interpretations are readily available, such crisis will be resolved through the introduction of a new dominant paradigm, and consequently a new mode of governance.

Indeed, when applied to the Chinese case, this framework demonstrates how periodic changes to economic governance resulted from unforeseen imbalances that necessitated a reconceptualization of economic paradigms.

However fervently debated by senior political figureheads and economists alike, ultimately the adoption of such alternative paradigms was conditional on the support of the paramount leader. If the general dynamic of paradigm shifts accurately describes the pattern of periodic and comprehensive change of governance witnessed in China, the matter of continuous investment, however, requires a more nuanced perspective. The imperative for the rapid accumulation of fixed capital derived from the Maoist-era strategy of industrialization. From the mid-1950s onward, both the rate of accumulation and the role of agriculture and industry were intensely debated, providing the conceptual groundwork for the readjustment and reforms of 1978. Yet none of China's central leaders refuted that economic development in the end depended on the continued expansion of fixed capital, nor that the state should retain a directive influence on the process of capital allocation. Instead, imbalances were responded to by way of reform (*gaige*, the partial reinstatement of market relations) and readjustment (*tiaozheng*, rebalancing of the investment rate between the sectors of the economy). Even as the state sought to grapple with the negative externalities of investment-driven growth (e.g. socioeconomic inequality, environmental degradation, the build-up of inefficient and idle productive capacity), it returned to the principles of diverting investment to relatively underexploited areas of the economy.

The incapacity or unwillingness to altogether abandon the concepts and techniques of Maoist-era governance demonstrates that the introduction of a novel paradigm does not necessarily imply the complete abandonment of its predecessor. The notion of promoting growth by way of the redistribution of investment in fixed capital persisted because it agreed with the normative values of the Party—importantly, it ensured the indispensability of the state in the processes of production and allocation, and allowed for the reapplication of extant techniques of control. Moreover, economic and political conditions in the latter half of the 1990s almost put an end to discussions about the objectives and mechanisms of economic development, precluding the articulation of a feasible alternative to investment-driven growth. As such, paradigmatic change in China has been a partial and fragmentary process through which certain concepts and techniques have been retained, others have been subject to redefinition, and yet others have been substituted or abandoned. In the chapters to follow, both the aforementioned changes and continuity in Chinese economic discourse and governance are explored in further detail.

In the second chapter, we examine the Marxist–Leninist influences and indigenous ideological innovations that lay at the basis of the Chinese communist paradigm, which centered on the transfer of agricultural surplus to the industrial sector through a system of depressed prices for produce. The agricultural

sector, however, soon proved incapable of simultaneously providing for the basic needs of the Chinese population and furnishing the input required for the continuous expansion of industrial capital. This resulted in the promulgation of two rival paradigms: the Maoist revolutionary economics epitomized in the Great Leap Forward, and the strategy of reform and readjustment that would provide the conceptual foundations for Deng Xiaoping's program in the late 1970s. In the third chapter, we discuss how the reforms introduced under Deng spelled the end of accelerated accumulation and removed the constraints on agricultural development imposed by the system of intersectoral transfers. However, reform proved incompatible with readjustment, as the state was incapable of curbing the wave of local investment and concomitant inflation unleashed by fiscal decentralization. Reinstatement of central controls, however, caused stagnation of growth. In the end, neither reform nor readjustment were able to provide a solution to the problem of sustaining rapid growth of productive capital under the auspices of the Party-state. Subsequently, the concepts of reform and readjustment would lose their prominent position in discourse. In Chapter 4, we discuss how Chinese leadership addressed the conundrum of inflation and stagnating growth by way of the assimilation of foreign economic concepts. While the introduction of fiscal policies that attenuated the control of SOE over China's banks and pervasive privatization appeared to signify an embrace of economic liberalism, these techniques actually bolstered the public economy and the central state's economic control. In fact, from the latter half of the 1990s onward, the practice of centrally directed investment in fixed capital was firmly reestablished, enabled by a new system of intersectoral transfers from private to public industry. In Chapter 5, we examine why this new centralism caused an intensification of the pattern of investment-driven growth, in spite of the stated need to address the detrimental consequences of the continuous expansion of productive capacity. We attribute this to the lasting influence of Maoist-era principles, which prompted central leadership to opt for solutions which perpetuated the deeply entrenched notions of state control and growth through accumulation. Chapter 6, the final empirical chapter, covers developments under China's new president Xi Jinping. Dwindling marginal returns to labor and capital affirmed the long-held concerns about the inherent limitations of investment-driven development. Nevertheless, the rate of accumulation has only been slightly reduced during Xi's tenure. In the latest iteration of the entrenched paradigm of accumulation-driven growth, the state has turned outward. Thus, the Silk Road "One Belt, One Road" initiative seeks to invest heavily in the infrastructural development of Sino-European trade routes, creating new demand for the outputs of publicly owned pillar industries such as steel, cement and

construction. This latest episode in Chinese economic development demonstrates how, in spite of a generally acknowledged need to fundamentally alter the course of Chinese economic development, elite conceptualizations of economic growth remain beholden to both the political imperative for continued central control and the industrial legacy of accelerated accumulation. Finally, in Chapter 7, we discuss in detail how our emphasis on discourse and policy illuminated certain previously overlooked aspects of China's development, and how the Chinese experience can further inform studies on economic discourse and the relation of this to economic governance.

# Primitive Socialist Accumulation, Readjustment and Reform (1953–1978)

## Introduction

In this chapter we focus on the Maoist economic paradigm, which, with minor interruptions, guided Chinese economic development until the reforms introduced by Deng Xiaoping in 1978. The strategy for economic development under the First Five Year Plan (1953–1957) relied heavily on Soviet theory and experience, and in the first decade of the Maoist era, the Soviet discourse would continue to serve as a referent for Chinese economists and leadership. In line with the work of Soviet economists Fel'dman and Preobrazhensky, Chinese leadership adopted a strategy of accelerated accumulation, wherein the appropriation of agricultural output provided the necessary investment for the planned expansion of industry.

Following the period of the First Five Year Plan, emerging economic imbalances prompted a reevaluation of the notions of centralized planning and the intersectoral transfer of resources. Various state leaders and economists called for the partial reinstatement of market allocation and a more balanced trajectory of growth. However, these suggestions failed to make a lasting impact. At times, Mao proved sympathetic to the notion of developing agriculture and industry on a more even keel. However, the Chairman seemed to have ultimately attributed problems of development to a lack of ideological rectitude among Party cadres and the working masses, rather than any intrinsic defect of the strategy of accelerated accumulation. Notwithstanding its marginal influence on Maoist-era economic policy, the economic discourse of the 1950s and 1960s had a profound impact on the Chinese state leaders who ascended to power in 1978. Deng Xiaoping's policies of economic reform and adjustment, which brought about a definitive break with the Soviet strategy of socialist development, were defined to a large extent by the discourse on market allocation and sectoral balance of the 1950s and especially the early 1960s.

We commence this chapter with a discussion of the foundational socialist theories, which concerned the instruments of allocation, the appropriate relations between industry and agriculture, and the material and ideological foundations of economic development. We then move on to describe the interdependent development of indigenous economic discourse, policy and the

Maoist-era Chinese economy. We discuss how Maoism stymied attempts to introduce market allocation, but ultimately failed to suppress support for reform and readjustment, which would subsequently provide the basic conceptual parameters for the development of China's economic paradigm of market socialism.

### Theoretical Foundations and Issues of Communist Development

China's Maoist economic paradigm was informed by three central concerns within socialist economy theory. The first of these related to the means by which resources would be allocated throughout the economic system. The second pertained to the means by which a developed, socialist economy could be established in the most expedient manner. At least during the Maoist era, the Chinese paradigm coincided with the Soviet interpretation on these first two issues. Where it differed most markedly, however, was with respect to the third issue, that is, the roles attributed to the material and ideological conditions within economic development. Below, we discuss these three theoretical issues in greater detail. Besides providing the discursive context for the development of the indigenous economic debate, this section gives a brief introduction of concepts that may be foreign to readers unfamiliar with Marxian theory and the economic discussions that prevailed within the Soviet Union in the 1920s.

#### *The Law of Value and the Law of Planned Proportionate Development*

Expounded in the first chapter of volume one of Marx's *Capital* and Engels' addendum to the third volume,<sup>10</sup> the law of value holds that the value of a commodity is determined ultimately by the amount of labor expended in its production.<sup>11, 12</sup> While demand and supply influence the exchange value of commodities (that is, the ratio with which one commodity is traded for

10 "Law of Value and Rate of Profit" appeared first as a supplement to the 1894 edition of the third volume of *Capital*.

11 On the difference between use value, exchange value and value (proper), see Marx (1992, ch. 1).

12 Marx states: "[T]hat which determines the magnitude of the value of any article is the amount of labor socially necessary, or the labor time socially necessary for its production" (Marx 1992, p. 28). By "socially necessary," Marx refers to the average labor time, given prevailing technologies and productivity.

another), the relative scarcity of commodities (or the capital utilized in their production) cannot explain that increment of differential value which remains when supply and demand are in equilibrium. Rather, this value must derive from an inherent feature shared by all commodities which is independent of the process of exchange. This commonalty, argued Marx, is the human effort (i.e. labor) expended in the act of production.<sup>13</sup> It follows that, under equilibrium conditions, prices within the market are primarily determined by the respective stocks of labor internalized within commodities. Although the above statement appears to be a general economic maxim in the vein of the labor theories of Adam Smith and David Ricardo, Marx considered his law of value to relate specifically to capitalism. The abstract notion of value—as something different from the immediate utility of a good, that is, its use value—within the capitalist mode of production could only develop due to the equally abstract form of commoditized wage labor.<sup>14</sup> It was because the amount (or rather hours) of commoditized wage labor expended in the production of one commodity could be directly compared to that in another that the value of each could be determined.<sup>15</sup> Through market competition, the law of value would spontaneously assert itself; competition would exert downward pressure on

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- 13 Moreover, the constitutive function of labor within value was held to remain even in the face of fluctuation resultant from commodity circulation, although expressing itself as a tendency rather than a fixed proportion. See Engels, “Law of Value and Profit,” in Marx and Engels (1990).
- 14 When discussing the law of value, Marx refers not to “concrete labor,” i.e. the specific task preformed in order to produce a particular item (e.g. the sewing required to produce a shirt), but rather to “abstract labor,” i.e. the general, undifferentiated act of producing value. Under capitalism, such abstract labor is exchanged within markets much like other factors of production, hence “commoditized” (see Marx 1992, ch. 1).
- 15 Although the law of value provided the main allocative principle within capitalist economies, Marx held that the prices of production—that is, the price point at which a particular commodity generally tends to be sold—to be only broadly constrained by, but not determined by, the law of value. Rather, the price of production is constituted by the costs of production—including those expended on labor, and the objects (i.e. material) and instruments of labor—and an average rate of profit. The average rate of profit in turn is determined by the realized surplus value, that is, value created by labor that is not restituted to the worker by way of wages. Since surplus value is created through the expropriation of labor value, the rate of profit depends on the ratio between constant capital and labor within production; what Marx calls the organic composition of capital. It follows that in industries where the organic composition of capital is lower (i.e. labor-intensive production) the rate of profit would be higher (Marx and Engels 1990, ch. 45). The differences in the organic composition of capital between industries would result in persistently diverging rates of profit, were it not for the fact that competition would



prices, but producers would be unwilling to supply goods at prices below the cost of production.<sup>16</sup> This spontaneous and anarchistic process of regulation by the law of value would,<sup>17</sup> however, prompt aberrations in supply and demand, causing the capitalist mode of production to undergo constant fluctuations and periodic crisis.

The socialization and unification of production would abolish the law of value, eliminating the irregularities of capitalist production and the wasteful duplication of effort and resources impelled by competition. Rather, production under socialism is governed by the law of planned, proportionate development. The overall objective of planned development was to be ultimately provided by the economic law of socialism, defined by Stalin as follows: “[M]aximum satisfaction of the constantly rising material and cultural requirements of the whole of society is the aim of socialist production; continuous expansion and perfection of socialist production on the basis of higher techniques is the means for the achievement of the aim” ([1952] 1972, p. 80). This required proportionate economic development, and first and foremost an appropriate relationship between the means of production and the production of consumer goods.

Realization of the continuous increase of production would require the rapid and comprehensive expansion of heavy industry, which provides production technology (Institute of Economics of the Academy of Sciences of the USSR 1957, ch. 30). Eventually, planned and proportionate economic development would become the purview of the people. However, in the interim period, in which the material basis remained relatively underdeveloped and the socialization of production incomplete, the task of planning would fall on the state. Opinion differed on how the state ought to proceed with the task of economic planning. In particular, controversy existed regarding the interpretation of “proportionate” development and the role of the law of value under socialism. The former issue will be discussed in detail in the next section. Here, we focus on the Soviet debate on the law of value.<sup>18</sup>

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prompt investment to flow toward industries with the highest rates of profit, resulting in excess production and causing industrial profits to converge to the average rate of profit.

- 16 The spontaneous operation of the law of value (akin to Smith's concept of the *invisible hand*) was referred to in socialist theory as “the economic law of competition and anarchy of production” (see Institute of Economics of the Academy of Sciences of the USSR 1957, ch. 4).
- 17 “Spontaneous” and “anarchistic” because the operation of the law of value was not coordinated by any particular actor or central authority.
- 18 Note that Marx's discussion of communism was limited to the “Communist Manifesto,” which enumerated a host of conditions characteristic of communist society (see chapter 2

It was generally understood that once the transition toward communism was completed, the law of value would dissipate.<sup>19</sup> After all, the law of value was in itself an artifact of capitalism, a result of the social relations of production that organized production into abstract labor and commodities. Under communism, workers would not toil for wages, but would work simply to fulfil social need, weighing material gains against the time devoted to labor (Bukharin and Preobrazhensky 1966). In consequence, the intermediary concepts of exchange value and production prices could be dispensed with, and the organization of production would be based directly on labor time and use value. However, in the transition from capitalism to communism, when the material conditions of production would have to be developed, accumulation, and thus the creation of surplus value, would remain a necessity. Moreover, until the socialization of ownership was completed, planned and commodity production would exist side by side. Some—notably the Russian economist Evgenii Preobrazhensky—argued that the laws of value and planned, proportionate development were inherently incompatible and antagonistic. Accordingly, the objective of socialist development was to expand socialist production by the progressive incorporation of capitalist commodity production into the state-controlled industrial complex, promoting the twin objectives of the development of the factors of production and the relations of production (Freeman, Kliman and Wells 2004, ch. 13).<sup>20</sup> Preobrazhensky formalized his perspective in the theory of accelerated accumulation (see the following section), which would provide the foundation for the Chinese strategy of industrialization.

However, Stalin, whose writings also exerted considerable influence on the initial Chinese economic strategy,<sup>21</sup> held a different opinion. During socialist development, labor would be compensated with consumer goods. He argued that, while the nature of these commodities would be specified by plan, the law of value would still influence their production by determining their relative exchange ratios. Moreover, Stalin saw use for prices reflecting the law of

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of the manifesto), but did not expound the actual organization of the system of production, or the concrete means by which to transit from capitalist to socialist, and eventually, communist society.

- 19 Value, like the law of value, is a historical category connected with the existence of commodity production. With the disappearance of commodity production, value and its forms and the law of value also disappear (Stalin [1952] 1972, p. 22).
- 20 The factors of production are comprised of labor and capital; the relations of production refer to the social organization of production. We discuss these concepts in more detail in the following sections.
- 21 That is, during the period of the First Five Year Plan. However, the Stalinist model would subsequently be heavily criticized by Mao, see Mao (1969).

value within national accounting, believing it would incentivize producers to focus on productivity and efficiency (Stalin [1952] 1972, ch. 3). He did, however, categorically dismiss the idea of allowing the law of value to exert its regulatory function. Said Stalin: “[If] the law of value regulates the ‘proportions’ of labor distributed among the various branches of production . . . it would be incomprehensible why our light industries, which are the most profitable, are not being developed to the utmost, and why preference is given to our heavy industries, which are often less profitable, and sometimes altogether unprofitable” (Stalin [1952] 1972, pp. 22, 23).

A similar divergence in perspectives on the utility and ideological stature of the law of value would come to characterize the Chinese debate, resulting in heated debate between China’s leaders. The implications of this discussion were extensive. Discussions on efficiency criteria and price calculations would be unthinkable without a discussion of commodity production and exchange and the law of value. Moreover, because Preobrazhensky had directly associated the laws of value and planned, proportionate development with the operation of commodity (e.g. consumer goods) and socialist production respectively, the discussion on prices became inextricably related to the central issue of sectoral development.

### *Accelerated Accumulation and Balanced Growth*

In Marx’s analysis, growth depends critically on the economic system’s capacity to consistently produce surplus value that can be reconverted into productive capital. Simple reproduction occurs when economic activity only creates value sufficient to replenish the stocks of capital and labor expended in that instance of production. Accumulation, by contrast, requires the creation of surplus value (that is, value in excess of the sum invested in capital and labor), which is then used to expand the means of production (Marx 1992, ch. 24). At the aggregate level, accumulation depends on the relationship between the agricultural sector (department 2), which produces goods for direct consumption and the industrial sector (department 1), which manufactures the instruments of production. The industrial sector can be further divided into two parts, that which produces equipment for its own enlargement (i.e. basic or heavy industry (department 1a)) and that which manufactures the means of production for agriculture (department 1b). For accumulation to take place, part of the realized surplus value must be reinvested in industry.

### *Feldman’s Theory of Accumulation*

The first economist to focus attention on how the relationship between departments 1 and 2 affected the rate of economic growth was the Soviet economist

Fel'dman.<sup>22</sup> According to Fel'dman, when investment is allocated in a manner proportionate to the respective stocks of capital in both departments, the economy will grow in a steady fashion. For the rate of accumulation to accelerate over time,<sup>23</sup> the proportion of investment in department 1 must be greater than the proportion of investment in department 2. In other words, to initiate rapid economic growth, it is necessary to rapidly expand the capacity of the producer goods sector.<sup>24</sup> Such accelerated growth will increase the capacity of department 1a in proportion to departments 1b and 2. The output of sector 2 will continue to grow, although its share of total economic output declines each year. However, because industry manufactures producer goods for agriculture, the efficiency of agricultural production is increased, yielding greater surplus value. This surplus value can subsequently be reinvested in the development of department 1. Fel'dman concluded that by following a strategy of accelerated growth the whole economy would eventually permanently shift to a trajectory of higher growth, although the rate of growth of department 2 output would be temporarily reduced. The time span of this transition would depend on the allocation of capital stock between 1a and 1b in industry at the initial point of takeoff, and on the proportion of output in department 1 allocated to 1a and 1b respectively. Fel'dman's two-sector model of accelerated economic growth, emphasizing heavy industry, became the basis of the economic strategy followed in the USSR until the mid-1950s (Nove and Nuti 1976) as well as in China during the First Five Year Plan.

### *Preobrazhensky and Primitive Socialist Accumulation*

The development of heavy industry, which is the crux of the Fel'dman model, hinged on the transfer of resources from agriculture to industry, such as industrial raw materials and grain supplies for the rapidly expanding urban workforce. In other words, sustaining an accelerated rate of accumulation would require the appropriation of increasing increments of agricultural output until industrialization is completed. Preobrazhensky's concept of "primitive

22 Fel'dman's growth model was originally published in the USSR in 1928. It was introduced to Western readers by Domar (1957). It is discussed in Robinson and Eatwell (1973); Ellman (1979); and translated into English in Spulber (1964).

23 Under the material planning system utilized in socialist economics, the rate of accumulation is calculated as the proportion of fixed capital and working capital. See Bo (1956: pp. 45–62); *FBIS* 1983 (April 29), "Explanation of Terms Used in the Sixth Five Year Plan," Economic Report, No. 333. In order to ensure compatibility with more recent statistics and international conventions, we will instead provide the rate of gross fixed capital formation, which excludes land purchases and inventories.

24 Ellman (1979, pp. 112–150); Robinson and Eatwell (1973, pp. 272–293).

socialist accumulation” was the first to provide explicit support for the transfer of surplus value from agriculture to industry. Preobrazhensky argued that rapid industrialization would have to be sustained through state appropriation of surplus value from “sources outside the complex of the state economy”, that is, agriculture (Preobrazhensky 1965, p. 84). The transfer of agricultural surplus value was to be realized through the instrument of “price-scissors,” whereby the terms of trade of agriculture vis-à-vis industry would be artificially depressed by a regime of fixed low prices for agricultural products (see Knight 1995). Preobrazhensky said:

Proceeding from what we have said above, we can formulate this law [the fundamental law of primitive socialist accumulation], or at least that part of it which relates to the redistribution of material sources of production, in this way: the more backward economically, petty-bourgeois, peasant a particular country is which has gone over to the socialist organization of production, and the smaller the inheritance received by the socialist accumulation fund of the proletariat of this country when the social revolution takes place, by so much more in proportion will socialist accumulation be obliged to rely on alienating part of the surplus product of pre-socialist forms of economy and the smaller will be the relative weight of accumulation on its own production basis, i.e. the less will be nourished by the surplus product of the workers in socialist industry.

1965, P. 124

For Preobrazhensky, the model of primitive socialist accumulation provided not only the means of developing the material economic basis, but simultaneously contributed to the aim of socializing the means of production. By advocating the appropriation of surplus value from the commodity sector—and, moreover, by suggesting that the rate of transfer be positively related to the size of the commodity sector—the proportion of the socialist industry within the overall economy would continually increase.

### *Bukharin and the Limits to Socialist Primitive Accumulation*

Preobrazhensky’s views led to spirited polemics with Bukharin, who was in support of a modest rate of accumulation, a more balanced development of industry and agriculture, and non-exploitative agricultural economic policies.<sup>25</sup> Bukharin formed his views in the wake of the economic problems that resulted from the overambitious targets for accumulation and industrial expansion set

25 See Erlich (1960, pp. 3–97); Nove (1978, pp. 119–135); Spulber (1964, pp. 64–66).

out in the Soviet Union's First Five Year Plan (1928–1933). Bukharin warned against overstraining capital expenditure (i.e. accumulation) because this would lead to the arrest of construction already initiated, unfavorably affect other branches of the economy, increase the goods famine and ultimately retard overall economic growth: “In their simple-mindedness the ideologists of Trotskyism assume that the maximum annual transfer of means from agriculture into industry would suffice to secure the maximum rate of development for industry. It is however clear that this is not so. The greatest sustained speed is obtained by a combination in which industry develops on the basis afforded by a rapidly growing agriculture” (Bukharin 1928, p. 2294).

In contradistinction to Preobrazhensky and the Trotskyites, Bukharin thus argued for prioritization of agricultural development. Underlying this proposition was an understanding of sectoral interdependencies that was diametrically opposed to that underlying the concept of primitive socialist accumulation. The latter held that the productivity of agriculture could only be realized by the development of industry, and, in particular, that part producing producer goods for agriculture. As such, proponents of accelerated accumulation attributed the strained supply of grain in the late 1920s to the stunted development of industry (and department 1b in particular). Bukharin was rather of the opinion that the origin of this crisis lay in the discrepancy between the inflated prices for agricultural inputs to industry such as oil and cotton (impelled by the latter's increased capacity for production) and artificially low prices for grain (prompting the transfer of surplus value toward the industry), leading to the neglect of grain production. The solution of this problem, according to Bukharin, was twofold: first, the proportion of appropriated surplus value ought to be reduced to a ratio decisively below its “technical maximum” and, second, greater emphasis ought to be put on agricultural capital construction. Although Stalin, inspired by Fel'dman and Preobrazhensky, would eventually split with Bukharin and launch “the revolution from above” (Lorenz 1978), Bukharin's ideas enjoyed a renaissance in China in the wake of the collapse of the Great Leap Forward.

### *The Productive Forces and the Relations of Production*

Alongside discussions of the law of value and sectoral relationships, the debate concerning the relations of production and the productive forces constituted a third relative constant in Maoist economic discourse. The productive forces are comprised by the means of labor (the machinery, land etc. required to engage in production) and labor itself. By the relations of production, Marx signified the totality of social relations and interdependencies required to sustain a particular form or epoch of production and exchange (Marx and Engels

1990, ch. 45). Fundamental characteristics of the relations of production under the capitalism mode of production are the disjunction of labor and the means of labor, due to the latter's agglomeration in the hands of the capitalist class and the concomitant institutionalization of wage labor, and the capitalist appropriation of surplus value.

Marxist–Leninist economic theory holds that attainment of the socialist ideal critically depends on four conditions. The first of these, the completion of the socialization of capital, refers to the transformation of the relations of production. The socialization of capital in turn causes the dissipation of social obstacles to reproduction (e.g. rent-seeking, competition etc.) that exist under capitalism. The full development of the productive forces is realized through perfection of the understanding of material and technical conditions. Jointly, these two factors provide the requisite conditions for the total reproduction of productive forces; that is, the realization of the optimal economic state of the socialist system. Finally, the development of socialist consciousness ensures appropriate distributive relations, and prevents the potential reemergence of social obstacles to production. Whereas the understanding of material conditions and the internalization of the technology of material reproduction develops by an incremental process of learning and instruction, the transformation of social relations must be a revolutionary process. Theoretically, the respective emphasis on material and socialist conditions is dictated by the relative states of each, and most effort would have to be expended on the lesser developed of the two (Schran 1962).

In practice, the interpretative leeway provided by this rather abstract instruction caused a considerable divergence between Chinese and Soviet party leadership.<sup>26</sup> Within the USSR, Stalin unequivocally emphasized the development of the productive forces, embracing Taylorian concepts of work organization and Fordist standardized manufacturing techniques, deeming them natural complements to, and logical extensions of, central planning (Hughes 2004). No such overtures to the prowess of American industrial organization were made by Mao and his confidants. Mao condemned the forceful nature of the Soviet industrialization and collectivization process which had alienated

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26 As this study is concerned with economic development strategies, we will have to abstain from a further discussion of, for example, Mao's "timing theory" and "generative class theory," which he defined by analyzing the different stages of the socialist transition phase and associated forms of class struggle. For an introduction of the concept "timing theory" in connection with a discussion on Mao's views on the political–economic stages of socialist development, see Levy (1975). The concept of "generative class theory" was introduced in Brugger (1978).

the Russian peasantry by implementing ruthless economic and organizational measures. A similar division over the appropriate roles of technical and social consciousness would emerge between leaders within the Chinese state and Party. In general terms, the primary concern of economic bureaucracy was with the technical aspects of economic development. The CCP, with Mao at the helm, tended to emphasize the development of socialist consciousness amongst the working masses, combining a system of incessant and ubiquitous propaganda and organizational measures (epitomized in the Dazhai and Daqing models) with periodic mass movements such as the Great Leap Forward (Shambaugh 2007). However—as we will expound subsequently—despite Mao’s alleged obsession with revolutionary change, nothing in his general philosophical outlook argues against his belief in the model of primitive socialist accumulation.

By advocating the primacy of the “socialization of consciousness”—in contradistinction to Stalin—Mao set out a course for economic development that diverged markedly from that followed in the Soviet Union. Mao’s strategy of “big pushes,” seeking to elevate the economy to a higher level through the revolutionary reorganization of the relations of production, was fundamentally at odds with the economic policy of Khrushchev, which embraced partial market operation and lessened the prioritization of industrial development. These differences fueled intense mutual criticism by Chinese and Soviet Party leadership, and precipitated the breakdown of political relations between the two countries in the 1960s. While this heralded a period of increasing economic isolation for China, it also provided the conditions for the emergence of a prolific indigenous economic debate, which would prefigure the reforms and adjustments eventually introduced by Deng Xiaoping in the late 1970s. Below, we discuss the reciprocal development of China’s economic paradigm, and its economic and political conditions under communism in greater detail.

## Economic Discourse and Policy in the Maoist Era (1953–1977)

### *The First Five Year Plan (1953–1957)*

In the latter era of the Qing Dynasty, rapid expansion of the population, civil unrest and foreign incursion had resulted in economic stagnation and political impotence. While the establishment of the Republic of China in 1912 spelled the official end of two millennia of imperial rule, warlords continued to administer regions under their purview as local fiefdoms (Schoppa 2000). Constant turmoil and the perpetuation of pre-modern institutions obstructed the process of industrialization which had radically transformed relationships



of ownership and production in most of the Western world. China's economic backwardness, framed within the ideological backdrop of an inevitable clash between capitalist and socialist societies, led the CCP, seizing power in 1949, to regard rapid industrialization as the major imperative. Accordingly, the first of China's Five Year Plans (*wu nian jihua*) stated:

The adoption of a strategy of active socialist industrialization and the prioritization of heavy industry is necessary for the establishment of a strong army, satisfaction of the people's needs and the creation of a material foundation for a socialist transformation. Therefore, we must make the establishment of a basis for heavy industry the focus of the Draft of the First Five Year Plan for the Development of the National Economy.<sup>27</sup>

Essentially, the Plan contained five main points:

- (1) Highest priority was assigned to the development of heavy industry (producer goods industries);
- (2) Main attention was paid to 694 above-norm projects, the core of which were 156 projects to be constructed with Soviet help and assistance;
- (3) New industries were to be located close to raw material bases;
- (4) Increases in wages were to be kept below increases in the productivity of the working force in order to maintain capital accumulation;
- (5) Agriculture was to concentrate on the production of grain and industrial raw materials. Focus was to be put on the need of increasing the agricultural surplus product in order to finance industrialization (Li 1955).

In sum, the First Five Year Plan assigned agriculture to function as the accumulation base for the development of industry, and within the industrial sector the accumulation rate of heavy industry was emphasized. The CCP's template for economic development thus reiterated the basic tenets of the theories of Fel'dman and Preobrazhensky. However, both economic and social conditions and political factors in the 1950s caused the Chinese socialist paradigm to diverge from the Soviet template. Soviet communism had been established with the support of a discontented industrial proletariat. China, on the other hand, had not yet produced an industrial workforce capable of unleashing a communist revolution. Rather, the peasant class provided the basis for China's socialist development. Due to the backward state of its predominantly agricultural economy, China had yet to reach the stage of economic modernization

<sup>27</sup> *Zhonghua renmin gongheguo* (1955: ch. 1).

at which it could sustain full-scale accelerated accumulation on the eve of its First Five Year Plan in 1952. By contrast, Russia had already reached this stage at the turn of the 20th century (Rostow 1960). Table 2 illustrates the comparatively unfavorable Chinese socioeconomic setting.

The implications of these contrasts appear clear. The Soviet strategy, based on the Fel'dman model and Preobrazhensky's "law of primitive accumulation," centered on extracting resources from agriculture to provide capital for heavy industry. This was feasible in the Soviet Union, which boasted a relatively favorable resource base and sizeable grain surplus. In China, the imminent concern was to increase agricultural production to a point at which would be a surplus at all (Yeh 1967).<sup>28</sup>

TABLE 2 *Total and per capita output of selected products in China and the Soviet Union at the outset of their First Five Year Plans*

	China (1952)	Soviet Union (1928)
Population (mln.)	575	147
Urban population (%)	12	19
GNP per capita (1952 US dollars)	50	240
Cultivated land per rural capita (acres)	0.7	2.3
Grain output per capita	272	566
Per capita industrial output		
Coal (kg)	111.65	241.5
Steel (kg)	2.37	28.91
Crude oil (kg)	0.77	78.03
Cement (kg)	5.03	12.59

SOURCES: CHEN AND GALENSON (1969, PP. 35, 37); ECKSTEIN (1966, P. 20); WORLD BANK (1983, P. 43); YEH (1967, PP. 327–363, 349).

28 The importance of agriculture to Chinese industrialization was acknowledged in the First Five Year Plan. "Agriculture furnishes the conditions for the development of industry. Just like comrade Mao Zedong has said in his 'On coalition government': 'The peasants . . . are the main actors within the Chinese industrial market. Only they can provide abundant grain and raw materials, and absorb the major part of industrial products,'" *Zhonghua renmin gongheguo* (1955: ch. 1).

Although China was economically far weaker than the Soviet Union of the late 1920s, agricultural output rose significantly in the former in the early years of the First Five Year Plan. Importantly, the collectivization of agriculture in China had been a much smoother process than in the Soviet Union. Initial support for the communist cause to overthrow the landlord class (Selden 1995) had also rendered China's peasants more receptive to the Party-state's agrarian policies. These policies reiterated the Marxist assumption that socialized industry and collectivized large-scale agriculture are fundamental prerequisites of socialist economic development and growth.<sup>29</sup> During the first stage of collectivization, output rose significantly, seeming to confirm the wisdom of the adopted agrarian policies. However, the relatively low rate of growth in agriculture during 1956 and 1957 called into question the feasibility of maintaining the rapid rate of industrialization envisaged in the First Five Year Plan. Several amongst China's economic leadership became convinced that the adoption of the Soviet development strategy was altogether incompatible with the realities of the Chinese setting.

Notably, it appeared that this assessment was shared by Mao. In an enlarged session of the Politburo (*zhengzhiju*) in April 1956, Mao delivered a seminal speech, "On the Ten Major Relationships." This speech seemed to indicate that Mao was the *primus motor* in breaking away from the Soviet development strategy in favor of a strategy of "walking on two legs"<sup>30</sup> (*liang tiao tui zou lu*):

The root cause of the failure to increase agricultural production in some countries is that the state's policy towards the peasants is questionable. The peasants' burden of taxation is too heavy while the price of agricultural products is very low, and that of the industrial goods very high . . . Our current predicament is that we must appropriately adjust the investment ratios between heavy and light industry and agriculture and increase the development of agriculture and light industry.

MAO 1977, PP. 285–286

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- 29 Karl Marx took it for granted that small-scale agricultural production was doomed: "Large industry and large agriculture on an industrial scale work together" (Marx and Engels 1990, p. 946). Engels, Kautsky and Lenin never questioned this basic assumption of Marx. Stalin followed in their footsteps by launching the collectivization drive in the late 1920s.
- 30 Indeed, "On the Ten Major Relationships" has often been referred to in secondary literature to bolster the claim that Mao sought to fundamentally alter the Chinese strategy of economic development (see Simonis 1968).

In fact, although Mao stressed more balanced development, he did not disassociate himself from the imperative of heavy industry growth:

In the future we must put more investment into light industry and agriculture so that the proportion of investment they receive is increased. When we increase this proportion, does this mean that we have changed the key sector? No, the key sector has not been changed. It is still heavy industry, but more emphasis will now be put on light industry and agriculture.

IBID.

As such, Mao sought not to radically alter the relationship between the economic departments, but still clung to the Soviet paradigm for economic development. The upturn in agricultural productivity was to be predominantly achieved through the aggregation of farmland in massive communes. The discussion on sectoral adjustment, however, came to serve as an entry point for a more comprehensive discussion regarding the mechanisms of coordination and distribution of control (Brødsgaard 1983a). Opinions diverged considerably on the appropriate distribution of fiscal influence over the center, local government and the collective. Chen Yun, who headed the State Capital Construction Commission (*guojia jianshe weiyuanhui*) was most radical in his perspective. Speaking at the eighth congress of the CCP in 1956, Chen—while careful to praise the great advances made toward the establishment of socialism—emphasized a number of emerging problems. Chief among these were the deterioration of product quality and diversity within the consumer goods sector and part of socialized industry, and the decrease of rural non-agricultural production (Chen 1956). These problems, argued Chen, were a result, in no small part, to the premature abandonment of market prices.

The solution, in Chen's (1956) view, would be the partial reinstatement of the principle of market exchange within department 2 (i.e. the consumer goods sector), by substituting the unified planning system with a stratified system wherein planning and market exchange would coexist. Factories within department 2 would procure the objects of labor (i.e. raw material) themselves, and sell their output. By reinstating the principle of market exchange, factories were expected to become more attentive to the costs associated with the procurement and use of material, lest increases in the ratio of constant to variable capital would erode the rate of profit.<sup>31</sup> The state would maintain a monopoly

31 Note that Marx, in distinction to neoclassical economics, understood constant capital to include the material inputs to production. The reason for this is that Marx used "constant" to denote that the value of this capital did not increase or decrease in the process

on the purchase of commodities such as cotton, coal and sugar in order to ensure sufficient supplies and maintain market stability. In the purchase of consumption products for daily use, the state commercial departments would have priority, but remaining products could be marketed either by the factories, or by commercial departments acting as their commission agents. Within agriculture, too, market exchange and production prices were to assume a greater role. By allowing subsidiary agricultural production to be governed by the market, Chen stated, product diversity would be enhanced. Moreover, the reinstatement of production prices would allow production teams to retain part of their realized surplus value, which could subsequently be reinvested to expand subsidiary production. When, shortly after the eighth Party congress, Chen was elevated to the position of vice-chairman of the CCP, his proposals likewise increased in influence, and became a focal topic of discussion in China's leading economic journals.<sup>32</sup>

However, Bo Yibo, chair of the State Economic Commission, was convinced that economic success was strongly dependent on full exploitation of the "socialist advantage" of centralized planning:

No matter whether it concerns the deployment of construction or the allocation of investment, or the confirmation and planning of production indicators, whether it involves the adjustment and allocation of raw material and products, all of these must proceed from a holistic perspective, so as to guarantee the focal points and consider the general; our nation's limited labor, material and fiscal resources must be rationally utilized where the need is most pressing, their effect most prompt, and their use the greatest. To do this, we must most certainly consolidate command and unify planning.

BO 1956, P. 52

Within the State Planning Commission (*guojia jihua weiyuanhui*), by contrast, a concern arose that centralized planning was unfit to effectively deal with the

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of production (but merely transform). By contrast, only labor can increase the value of materials, through the latter's refashioning in novel products.

32 Thus, writing in the journal *Jihua Jingji*, Xue Muqiao (1957a; 1957b), the director of the State Statistical Bureau, agreed with Chen Yun regarding enlarging the role of the market in order to stimulate economic growth. In articles published in the journals *Tongji gongzuo* and *Jingji Yanjiu*, Sun Yefang (1956; 1957) went even further by arguing that all planning and statistical work should be based on the law of value and that profits should function as the main indicator of enterprise efficiency.

diverse industrial conditions and demands of the localities. Therefore, members of the commission advocated decentralization of control to subnational levels of government (Donnithorne 1964).

The opinions of Bo and Chen pitted them against Mao, who had great reservations about the proliferation of central bureaucracy and categorically dismissed the possibility of introducing market allocation. The consolidation of economic decision-making power within the bureaucratic planning organs could potentially undermine the authority of the CCP, which was based on the support of the masses (Lieberthal 1997). Likewise, the notion of introducing capitalist relations of production contravened Party ideology. Mao insisted that “basic construction ought to strengthen the leadership of the Party and mobilize the masses” (1958). Mao’s statement reflected his strong emphasis on the development of the “socialist consciousness” at the expense of the technical requirements of production. Chen Yun’s proposal would eventually cause an ideological rift between the economic bureaucracy, whose perspective on economic development emphasized the technological qualities of economic production and coordination, and a more radical Party faction, in favor of a strategy of mass mobilization (Lieberthal 1997).

### *The Great Leap Forward (1958–1959)*

The Great Leap Forward was Mao’s response to three prominent issues within economic discourse. First of these was the aforementioned emergence of a “rightist” faction of economic leaders advocating the introduction of market forces. Second was the strategic issue of the imbalance between the agricultural and industrial sector that had arisen under the First Five Year Plan. Third, and straddling both of these issues, was concern about “major domestic contradictions” (*zhuyao guonei maodun*), which primarily related to the relations of production.

According to Mao, the central economic issue was that of the relations of production, and not the productive forces. Mao advocated a continuous revolution of the relations of production, consisting of changes in the ownership system, the relations among the agents within the production process and the system of distribution (Christensen and Delman 1983). Of these, Mao considered the transformation of ownership to be most important. In his “Reading Notes on the Soviet Union’s ‘Political Economy,’” Mao stated: “The revolution in the system of ownership is the base, so to speak” (1969, p. 347). This statement was motivated by Mao’s belief that the socialization of ownership would spur on the development of productive forces (i.e. the economic foundations): “First the relations of production have to be changed, then and only then can the productive forces be broadly developed. This rule is universal” (ibid.,

p. 370).<sup>33</sup> However, Mao believed that completion of the transition toward truly communist relations of production could not occur instantaneously, but would be contingent on having first completed structural transformation from an agricultural to industrialized economy. Until then, ownership would have to be invested in large communes. Not only did communal ownership serve as an intermediary approximation of communist organization of labor (as opposed to the capitalist “recidivism” advocated by Chen), but the construction of the communes would also serve to intensify the collectivization of agriculture, thereby providing both the socialist impetus and technical economies of scale and labor surplus necessary to realize an upturn in both agricultural and industrial productivity.<sup>34</sup>

In the years directly following the First Five Year Plan, the issues of “rightism,” productivity and domestic contradictions became the focal point of politics. At the third interim meeting of the eighth plenum of the CCP in September and October of 1957, an anti-rightist (*fan youpai*) campaign was launched seeking to purge the Party of revisionist elements. Chen Yun was ousted from politics in 1958, to return only after the failure of the Great Leap had become undeniable. Absent political opposition, the second session of the eighth Party congress, held in May of that year, was used to formally endorse the strategy of the Great Leap. The strategy consisted of two main components. First was the aforementioned establishment of the people’s communes. In 1958 the size of rural cooperatives was greatly expanded, from an average 160 to over 5,000 households (Dixon 1982, p. 4). In tandem with these structural reforms, the Party-state decentralized much of its administrative authority to the levels of local government and the communes. While the center still issued its production quota, the technical instrument of central planning was suspended in favor of a strategy of mass struggle, based on the “socialization of consciousness.” The socialization of the relations of ownership was reflected in the expansive welfare arrangements extended to the workers in the communes. The expansion of socialist awareness was further buttressed by massive propaganda campaigns stressing the crucial nature of continuous struggle (Shambaugh 2007).

These adjustments to economic organization, alongside a bumper harvest in 1958, bolstered the Party’s conviction in its capacity to realize a tremendous upsurge in economic output. On the basis of the anticipated economies of

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33 Mao seems to have derived this conclusion through empirical observation: “From the standpoint of world history, the bourgeois revolutions and the establishment of the bourgeois nations came before, not after, the industrial revolution” (1969, p. 346).

34 A strategy summed up by the Party slogan “communal first, then large” (*yi gong er da*).

TABLE 3 *Planning the Great Leap Forward: Production quota for grain and steel output for the year 1962*

	Grain (Ton)	Steel (Ton)
September 1956	500 m.	10–12 m.
August 1958	1.5 bn.	80 m.
June 1961*	310–320 m.	10 m.
Realized in 1962	160 m.	6.7 m.

\* Quota for 1963.

SOURCES: ZHOU (1956); GUOJIA JIHUA WEIYUANHUI DANGZU (1961); GUOJIA JIHUA WEIYUANHUI DANGZU (1958).

scale in agricultural production, the target for agricultural output was significantly adjusted upward. However, the potential to transfer surplus labor to department Ia caused production targets within industry (notably steel) to be increased by an even greater margin (see Table 3).<sup>35</sup>

Although the Great Leap Forward introduced significant changes into management and organization in both industry and agriculture,<sup>36</sup> it constituted an intensification, rather than a mitigation of or deviation from the Soviet strategy of accelerated accumulation. When Minister of Defense Peng Dehuai stated his grave concerns regarding the consequences of the Great Leap at the Lushan conference in 1959, Mao responded by removing Peng from his position and instigating another round of anti-rightist campaigning. It was in fact not until 1960, when the failure of the Great Leap had become indisputable, that the intensified pattern of accumulation was abandoned. A series of floods and draughts in 1959 had caused agricultural output to be much lower

35 During the heyday of the collectives in 1958, they came to account for approximately half of peasant incomes (Dixon 1982, p. 5).

36 In agriculture: the people's communes have no precedent in the Soviet policy on collectivization. In industry: the "Two participations, one reform and three combinations" system (participation of cadres in labor, workers in management, reform of rules and regulations, combination of leadership with the masses, labor with technique and technical theory with production practice) broke with the Soviet responsibility and incentive system of one-man management. These developments—although important—do not invalidate the argument that, as far as accumulation and the relationship between the main sectors goes, the Great Leap Forward represented intensification rather than a break with the Soviet strategy.



than anticipated. Moreover, the strategy of communization had not exhorted laborers to work more expeditiously, but rather induced inefficient labor practices and overconsumption. Nevertheless, communes and local bureaucrats, eager to appease the center, grossly exaggerated production achievements. While agricultural output dropped in 1959 and 1960, state purchases of grain were conducted on the basis of inflated harvest figures (Lippit 1975).<sup>37</sup> The result was a massive reduction in the amount of grain available for peasant consumption, which dropped to the low level of 92.5 billion kg in 1961, causing pervasive famine.

### *Readjustment and Consolidation (1960–1965)*

As the full extent of the economic crisis resulting from the Great Leap became evident in 1960, Chinese leaders embarked on a course that significantly altered economic priorities. In this process Mao retreated to the “second line,” occupying himself with foreign policy issues and ideology, and leaving the development of economic strategy to a group of senior Politburo leaders.<sup>38</sup> In the summer of 1960, a Central Work conference, convened at Beidaihe, decided to decisively change the priorities of economic policy. After this conference, the key slogan was changed from “simultaneously developing industry and agriculture with priority to be given to heavy industry” to “taking agriculture as the foundation and industry as the leading factor.”

Key measures for addressing the problems of the rural people’s communes were enacted in the November 1960 “Urgent Directive on Rural Work” (also known as the “twelve articles”)<sup>39</sup> and the May 1961 “Draft Regulations on the Rural People’s Communes” (routinely referred to as the “sixty articles”).<sup>40</sup> An end was demanded to the policy of “one equalization and two transfers” (*yi ping er diao*), which had promoted egalitarianism amongst China’s peasants by the communalization of farmland without compensation. Private plots, which had been confiscated in 1958, were returned to the peasants, and they were given permission to sell their products at rural trade fairs. The size of the communes, brigades and production teams was reduced and operational

37 Kung and Chen (2011) note that incentives for professional attainment also significantly contributed to administrators’ extraction of grain output to meet central quota during the Great Leap Forward.

38 Amongst whom, notably, were Liu Shaoqi and Deng Xiaoping.

39 For example, the output quotas of the teams should be fixed low enough to allow teams to achieve a surplus that they could retain as a “bonus,” see “Nongcun gongczuo jinji zhishi” (1960).

40 “Nongcun renmin gongshe tiaoli caocan” (1961).

authority decentralized. Through a contract system, brigades negotiated output quotas with the teams, which the latter then would guarantee. Within the three-level commune structure, it was required that accumulation was to be reduced in favor of consumption.<sup>41</sup> Furthermore, measures were introduced to avoid the excessive transfer of labor and resources from basic agricultural production to the many newly established commune-operated enterprises.<sup>42</sup>

Finally, production-based material incentives were extended (Teiwes 1979). Family sideline production was encouraged by allowing private plots on 5 percent of farmland acreage, and permitting trade on free markets after state quotas had been met. By these concessions official policy laid the basis for the so-called “three freedoms and one contract” (*sanzi yibao*), that is, the extension of plots for private use, the extension of free markets, the increase in the number of small enterprises that had sole responsibility for their own profits or losses, and the fixing of output quotas based on the individual households. The *sanzi yibao* spread widely, resulting in the virtual dissolution of the commune structure in large parts of China. By 1962 it was reported that in certain areas as much as 30–50 percent of land was under private cultivation (Chen 1969).

Important measures to deal with the crisis in industry were enacted in the December 1961 “Seventy Articles of Industrial Policy” (the “seventy articles”).<sup>43</sup> The stipulations of this document clearly indicated that Great Leap Forward policies had been reversed. Except for specifically authorized projects, capital construction was halted, thereby decreasing the growth rate of heavy industry. All industrial enterprises established without considering economic rationality and efficiency were to be closed down. Industrial production was to be oriented toward the market, and should satisfy the needs of the consumers rather than being oriented toward its own enlargement. Attention was also given to

41 The changes introduced in agriculture during the liberal interlude of 1960–1965 would provide the blueprint for the comprehensive reforms instigated under Deng Xiaoping from 1978 onward.

42 During the Leap years, a major concern was to utilize rural labor in non-agricultural activities during the slack season. Apparently, the peasants were asked to do too much non-farming work, and only 50 percent of the manpower was actually engaged in farm production (Tan 1960). As at least 80 percent of rural labor was necessary for farm work in the busy season, a severe labor shortage was reported (Ma 1961). Undoubtedly, the many newly established commune-run industries were partly to blame. The so-called “readjustment of labor power,” i.e. bringing the peasants back to agricultural production had become a chief concern by mid-1960. Of more than 20 million workers recruited from the rural areas between 1958 and 1960, 20 million were sent back from the cities in 1960 to engage in agricultural production (Liu, S. 1980).

43 “Gongye zhengce qishitiaozhuyao neirong” (1961).

improve the quality and variety of products. In sum, the new policies meant that capital investment had to be reduced, consumer goods industries and industries producing goods for the agricultural sector were to be prioritized, and quality rather than quantity was to be emphasized.

*Readjustment, Consolidation, Filling Out and Raising Standards*

At the ninth plenary session of the CCP convened in January 1961, the new official policy line was termed “readjustment, consolidation, filling out and raising standards” (*tiaozheng, gonggu, chongshi, tigao*). Readjustment (*tiaozheng*) referred to the correction of imbalances that had characterized the economy; most importantly: (1) an unduly high rate of accumulation, which had permitted little or no increase in living standards; (2) overaccumulation in heavy industry at the expense of light industry and agriculture; (3) overemphasis within heavy industry on metallurgical industries and neglect of such bottleneck sectors as energy and transportation. Consolidation (*gonggu*) and filling out (*chongshi*) pertained to the reinforcement of weak links in the production processes, the closing down of non-profitable enterprise and the concentration of production in efficient units. The filling out of existing capacity also involved completing essential projects and establishing a proper balance among various types of equipment within existing enterprises. Raising standards (*tigao*) related to improving the quality and variety of products, economizing on raw materials and fuel, and raising labor productivity.

The tenth plenary session of the CCP, convened in September 1962, noted that the policy of readjustment, consolidation, filling out and raising standards in the national economy and in strengthening the agricultural front had already yielded remarkable results.<sup>44</sup> The plenum approved a document entitled “Resolutions on the Further Strengthening of the Collective Economy of the People’s Communes and Expanding Agricultural Production,” which reemphasized the important position of agriculture in the national economy and set the order of priority in the economic plan as agriculture first, then light industry and finally heavy industry.<sup>45</sup> Moreover, the document stated that it was necessary to redefine the ratio of investment in conformity with the policy of designating agriculture as the foundation of the economy: “Investment in agriculture, including investments in industry, transportation, and scientific research which directly serve agriculture, should be systematically raised in proportion to the gross investment for economic construction.”<sup>46</sup>

44 “Communique of the Tenth Plenary Session” (1971, p. 188).

45 “Resolutions on the Further Strengthening” (1971, p. 195).

46 *Ibid.*, p. 196.

The plenary session also approved a revised sixty-article document, the “Revised Draft Regulations on the Rural People’s Communes.”<sup>47</sup> The draft regulations approved changes in the commune system that had taken place since 1961. Thus it was stipulated that production teams were to be the basic units of accounting and ownership in Chinese agriculture. The revised “sixty articles” also stipulated that the reorganized commune system would not be changed “for at least thirty years.”

The new eight-character policy of “readjustment, consolidation, filling out and raising standards,” giving priority to readjustment, entailed fundamental changes in the relationship between heavy industry, light industry and agriculture.<sup>48</sup> The role of agriculture was no longer to function as an accumulation base for heavy industry growth, as had been the case during the First Five Year Plan and during the Great Leap Forward. Instead, agriculture was assigned top priority, which, among other things, meant focus on increasing agricultural mechanization, improving irrigation, increasing application of chemical fertilizers and accelerating electrification. In other words, the government aimed to channel larger investments into the agricultural sector and, within the heavy-industrial complex, prioritize those sectors that produced agricultural machines, chemical fertilizers and insecticides, electric pumps for irrigation purposes and power equipment (department 1b output).

The changes within economic policy revived the debate on adjustment and reform that had been suppressed under the frenetic political climate of the Great Leap Forward. Whereas market and price reform had been the focus of the discussion during the “liberal interlude” of 1956–1957, the notion of readjustment now took center stage.

In the wake of the important Beidaihe conference of 1960, it was mainly *Hongqi* (the leading Party publication) and the national papers *Renmin Ribao* (*People’s Daily*) and *Guangming Ribao* that expounded on the consequences of the changing line for the relationship between accumulation and consumption. But after the ninth plenary session, China’s preeminent economic journal, *Jingji Yanjiu*, also picked up on the discussion. The debate conducted in *Jingji Yanjiu* encompassed three distinct lines of thought. The first school of thought, which was dominant until the tenth plenary session, was represented by, among others, Liu Guoguang, Yang Jianbai and Wang Xiangming. They suggested

47 “Nongcun renmin gongshe tiaoli (xuzheng caoan)” (1962).

48 Because of difficulties in definition, the discussion about the distinction between heavy and light industry and this distinction’s relation to the concepts of department 1 and 2 had been thriving since early 1957. For a thorough Chinese discussion containing references to articles on the subject, see Wang H. (1963). See also Chen (1967, p. 28).

that China ought to continue to adhere to the Fel'dman–Preobrazhensky paradigm of economic growth, stressing the supposed long-term growth of overall productivity and associated increases in average consumption levels. Liu Guoguang was keenly aware of the political implications of this tradeoff between interests in short- and long-term consumption. To minimize the necessary duration of accelerated accumulation, he suggested that a large increment of surplus value would be reinvested in production materials and technology, so as to maximize the pace of reproduction (Liu 1962). Yang Jianbai likewise asserted that in the “early stage of socialist construction,” the accumulation rate should be raised steadily in order to build up the foundation of heavy industry and to speed up expanded reproduction, but that it would be “inadvisable to continue raising the rate of accumulation year after year” once socialist construction had reached a certain stage, as “this is not compatible with the basic goal of socialist production: to raise the people’s living standard” (Yang 1962). Wang Xiangming added the important caveat that “the effect on improving the relationship between heavy industry and agriculture resulting from arranging and adjusting the internal proportions of heavy industry is sometimes even more advantageous than the arrangement and adjustment of the total level of production of heavy industry” (Wang 1962). In other words, Wang argued that the manufacture of more machines for agricultural production might be more helpful to the development of department 2 than just cutting back the scale of heavy industry.

The remaining schools of thought developed in response to the decision of the tenth plenary session to increase the ratio of investment in agriculture and industry which “directly served agriculture.”<sup>49</sup> The second perspective essentially extended the line of argument set out by Wang Xiangming. Thus, Yang Jingjie concurred that, during the First Five Year Plan, it had been necessary to emphasize the metallurgical and machine-building industries in order to rapidly establish a foundation for the industrialization of China. But with an industrial foundation basically established, it would be necessary to shift emphasis toward the agricultural sector. Accordingly, Yang advocated increasing capital construction investment in agriculture and department 1b, to promote the modernization (i.e. mechanization, electrification and use of chemical fertilizers) of the agricultural sector.

The third school, as it appeared in articles by Wang Xuzhuang and especially Xu Dixin, represented the first clear attempt to shift to a paradigm of economic thought that truly prioritized the development of agriculture. Wang Xuzhuang criticized the view that the rate of transfer of surplus value from agriculture

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49 “Resolutions on the Further Strengthening” (1971, p. 196).

was to be determined by the demands of industry. He claimed that in the final analysis, the rate of socialist reproduction was determined by the capacity of agriculture to generate surplus labor (i.e. surplus product). This surplus labor, argued Wang, is manifested in the commodities, food and raw materials not used for simple reproduction, whether in their initial form or transformed into accumulated capital through exchange for industrial products (Wang 1963, p. 21). Moreover, since the transfer of agricultural laborers to non-agricultural labor is dependent on increases in agricultural production and labor productivity, Wang argued that “the farm population that has changed to non-farm population is in reality a portion of the surplus labor created by agriculture.” Finally, the scale of the agricultural market for industrial products also depended on the volume of agricultural production: “This is to say that it is not that the peasants are able to sell a large volume of agricultural products as a result of their purchases of a large volume for industrial products. The opposite is the truth.” Accordingly, Wang concluded that the appropriate economic strategy would be to “arrange industrial production and construction and the speed and extent of their development in accordance with the capabilities determined by the supply of commodities, grain and raw materials, capital, labor and markets agriculture can provide” (Ibid., p. 27).

Xu Dixin went further still in emphasizing the predominance of the agricultural sector in economic development. He too stated unequivocally that the level of agricultural development determined the rate and scale of industrial development. He likewise reiterated Yang Jingjie’s statement that industry must provide agriculture with sufficient technical equipment and facilitate the “technical transformation of agriculture,” but added that the technical transformation of agriculture was the precondition for rapid industrial growth, not the other way around. Xu concluded that “the development of industry depends not only on the machinery, raw materials, and materials that can be provided by industry itself, but what is more important, on the quantity of marketable grain that can be provided by agriculture” (Xu 1962, p. 1). The view that, after completing the “technical transformation,” agriculture would no longer serve as the foundation of the national economy was criticized by Xu Dixin. Agriculture remained the foundation “whether in the past, at present or in the future”: “It is wrong to judge the role of agriculture as the foundation of the national economy simply on the basis of changes in the ability of agriculture to provide grain and labor.” By unequivocally prioritizing the development of agriculture over that of heavy industry, Xu clearly departed from the Fel’dman–Preobrazhensky paradigm of economic growth and construction.

The Fel’dman growth strategy focused on extensive growth (extensive expanded reproduction). A sign of the shift to a new paradigm of economic

thinking was that Chinese economists increasingly came to stress the importance of intensive growth (intensive expanded reproduction), that is, sources of growth that did not necessitate an increase in the accumulation rate and/or the expansion of the industrial labor force. Dong Fureng (1963; 1964), for example, pointed to the importance of increasing labor productivity as a way of ensuring sustained growth, and Dong Yuanshi (1962) advocated a more efficient use of labor and capital. Although Mao had continued to advocate the principle of accelerated accumulation even in the wake of the Great Leap Forward,<sup>50</sup> his influence in economic affairs was waning in comparison to that of readjustment-minded leaders. Accordingly, agricultural development had become the main priority from 1961 onward.<sup>51</sup> Further development of this policy was, however, disrupted by the Cultural Revolution, which lifted Mao out of the relative obscurity of the second line and once again put the socialization of consciousness center stage.

### *The Roles of Price and Profit Reevaluated*

In tandem with the discussions of the appropriate relations between the industrial and agricultural sector, the debate on the law of value and the associated concepts of concomitant price and profit reemerged. In his article "On Value," Sun Yefang (1959) related the economic malaise of the Great Leap directly to the neglect of the law of value. According to Sun, Chinese economists had been too eager to condemn the law of value,<sup>52</sup> which they perceived to be inextricably related to capitalism and its vicious cycles of overexpansion and recession. While others had believed the vices of capitalism could be surmounted by abolishing private ownership and market production and exchange, Sun argued that stable and orderly economic development hinged on state control over prices. Nevertheless, if the (subjective) policies of government were to instill economic stability, they would have to adequately reflect the objective principles of value and utility. Thus, to Sun, the law of value was not the hallmark of capitalism, but rather a universal economic rule.

50 In his "Reading Notes on the Soviet Union's 'Political Economy'" (Mao 1969, p. 251), dating between 1960 and 1962, Mao stated that "priority growth in producing the means of production is an economic rule for expanded reproduction common to all societies."

51 "Guanyu yinfa di san ge wu nian jihua san ge wenjian de tongzhi" (1964).

52 In 1958, during the heyday of the Great Leap Forward, Chen Boda, then editor of the main Party periodical *Hongqi* and close confidant of Mao, had triumphantly proclaimed the demise of commodity production and the law of value.

This perspective was not without its detractors. Dai Yuanchen (1964) maintained that the law of value was fundamentally at odds with the socialist system. In Dai's view the cost of labor within the capitalist system did not reflect the value created by labor, but rather the capitalist's capacity to extract surplus value through the subordination of the working class. Nevertheless, Sun's opinion on the importance of the law of value was shared by many of his contemporaries.<sup>53</sup> This prompted extensive discussions on reform of the means of allocation (Lin 1981). The increased function of the law of value in regulating production depended crucially on determination of the rate of profit (i.e. surplus value). Up until then—and in line with the prescriptions offered by Stalin in his 1952 exposition—the 'profit' component in price formation had served solely as a means of national accounting, reflecting centrally stipulated rates of transfer between the agricultural and industrial sector. Following the pioneering work of Sun and others,<sup>54</sup> economic discourse in the first half of the 1960s came to center on the matter of how the instrument of profits could guide production in such a manner that it would accord with the law of value. Common to the various proposals was the notion that the increment of surplus value within a product's price would be somehow proportionate to that realized within the overall economy.<sup>55</sup> Certain economists maintained that, in keeping with the traditional labor theory of value, the rate of profit ought to be determined on basis of the proportion of labor costs (Wang, Z. 1963; Bai 1964; He, Xue and Peng 1964).<sup>56</sup> Others (Zhang and Zhao 1964) objected to such a method, arguing that the resultant increase of prices of agricultural products and commodities would effectively put a halt to the intersectoral transfers necessary to sustain accelerated accumulation. Instead they proposed profits should be computed rather as a fraction of production costs (which entailed both wages and material expenses).

In 1963, the most radical line of thought emerged (Yang 1963; He and Zhang 1964; Yun 1964). According to this perspective, productivity was primarily determined by the instruments of labor (i.e. capital) rather than labor itself.

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53 Notably by Mao, who in 1959 condoned elaboration on the topic by stating that "the law of value is a great school; only if we use it, teach our millions of cadres and masses about it, can we build socialism and communism" (quoted in Lin 1981, p. 19).

54 For example, Xue Muqiao, who served as deputy director of the State Planning Commission and head of the State Price Commission (*Guojia jiage weiyuanhui*).

55 I.e. surplus value ( $m$ ) would be expressed as a fraction of total surplus value ( $M$ ) realized within the economy.

56 See Marx and Engels (1990, ch. 45).



Since greater productivity would imply a more parsimonious use of labor, strict observance of the labor theory of value would actually result in the comparative neglect of the most productive industries within the economy. Because capital, rather than labor constituted the primary determinant of productivity, the third school, also called the school of production prices, advocated that the rate of profit should be calculated on basis of the fraction of total capital employed in production of a particular commodity. According to critics this amounted thus to nothing less than a refutation of the Marxian labor theory of value, which formed the basis of the Chinese socialist economy.

### *The Cultural Revolution*

In late 1965, Mao, alarmed by what he perceived to be the emergence in China of the same revisionism that had corrupted the socialist cause in the Soviet Union,<sup>57</sup> instigated the Cultural Revolution. During these turbulent years, leaders that had advocated economic reform and the readjustment of the strategy of economic development were once again ousted from positions of influence. In tandem, the academic discussion on reform and readjustment came to an abrupt end. Publication of *Jingji Yanjiu* and other economic journals propagating revisionist and intellectualist opinions ceased, not to reappear until 1978.<sup>58</sup> With Mao once again at the political epicenter, the pattern of the Great Leap Forward reemerged. Thus, the emphasis on technological expertise faded as “redness” (i.e. ideological correctness) became the focal point of the Cultural Revolution, and mass struggle was once again prioritized over the revisionist technique of economic planning. The concurrent decentralization of decisions on industrial development and emphasis on ideological zeal prompted a volatile pattern of accumulation driven by local government. Local imbalances were compounded by the center, which initiated the construction of an inland industrial basis (Naughton 1988). The so-called Third Front (*san xian*) was to preclude the disruption of the national economy in the case of a foreign incursion by shifting industry toward the remote southern and western Chinese provinces and ensuring regional economic autarky through the establishment of cellular, self-sufficient regional industry.<sup>59</sup> Notwithstanding the

57 See Mao (1958; 1974).

58 The tone of the debate in *Jingji Yanjiu* already began to change by September 1964, and by the end of 1964 the attack on production prices had a wider aim: to question the whole spectrum of the reform program.

59 “Expediting the construction of the Third Front is a major strategic decision of tremendous historical significance made by the Chairman in 1964. We must heed the instructions of the Chairman and swiftly construct the Third Front, and gather the nation’s labor,

reconciliatory stance he had taken in the years directly following the First Five Year Plan, Mao would thus continue to insist on the implementation of the Fel'dman–Preobrazhensky paradigm during periods of political autonomy.

Although the Great Leap Forward and the Cultural Revolution have commonly been interpreted as erratic attempts by Mao to maintain his political significance in the face of the development of an increasingly independent state, Mao's strategy of mass mobilization, socialist indoctrination and militaristic production was in no manner inconsistent with his interpretation of the Fel'dman–Preobrazhensky paradigm. The dual requirement of developing the material (i.e. technical) and social popular consciousness within Marxian diagnostic economics left open the question of the prioritization of the two. Mao considered the revolutionary process of the socialization of consciousness the primary condition for the realization of accelerated accumulation and the eventual completion of the transition toward socialism. Thus, when faced with an insufficiently productive agricultural sector, the organizational form of the commune—which constituted an apparent advancement toward the communist ideal of ownership by the people, and moreover provided economies of scale which would allow for the transfer of rural labor toward industry—appeared as a logical solution. Yet, while under the movements of the Great Leap Forward and Cultural Revolution capital investments increased sharply, they also induced an unsustainable strain on agricultural production, systemic inefficiencies in allocation and a neglect of the technological conditions of production. These changes had been accompanied by a momentous change in discourse. Whereas the discussion of the economy in the early 1960s had been characterized by exchanges between several schools of thought, during the Cultural Revolution the dogma of the revolutionary left became the sole legitimate line of thought. It would not be until the death of the Chairman and the subsequent ousting of the “Gang of Four”<sup>60</sup> in 1976 that political conditions allowed for the abolishment of the Fel'dman–Preobrazhensky paradigm and the politics of mass struggle.

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material, finances so as to gradually build up the defence industry, natural resource, materials, fuel, power, machine and chemical industries and the transportation and logistics system, and let the Third Front become a large-scale strategic rearguard. This relates to the overall deployment of the third Five Year Plan.” See “Guanyu di san ge wu nian jihua anpai qingkuang de huibao ti'an” (1965).

60 The Gang of Four (*si ren bang*), a strongly leftist clique comprised of Jiang Qing, Zhang Chunqiao, Yao Wenyuan and Wang Hongwen, rose to prominence during the Cultural Revolution.

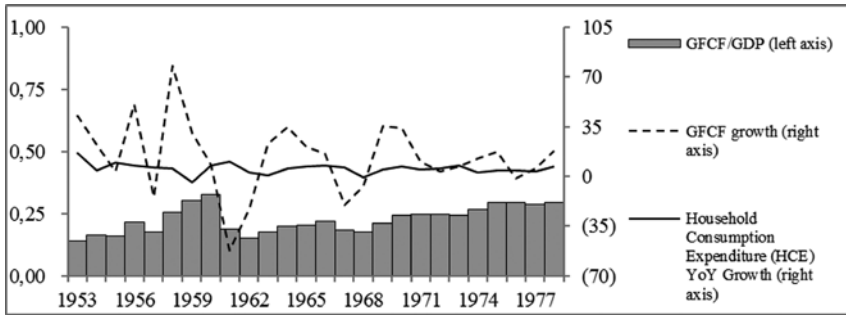


FIGURE 3 *GFCF as ratio of GDP and percentage growth (%), 1952–1978.*  
SOURCE: NBS (2005, TABLE 10).

### Economic Development under the Maoist Economic Paradigm

On the whole, economic development in the Maoist era displayed the distinctive characteristics of primitive socialist accumulation. GFCF consistently accounted for a large share of GDP (see Figure 3). The erratic pattern of growth of GFCF reflects the alternation of periods in which the Party-state pursued the rapid expansion of industry and a more balanced strategy of development.

During the Great Leap Forward the rate of GFCF shot up by 78 percent from 1957 to 1958, and at the end of the Great Leap, investments in gross fixed capital came to account for 32.5 percent of GDP. Not only did capital construction climb to excessively high levels in the Leap years of 1958–60, but the sectoral imbalances that had appeared under the First Five Year Plan period were greatly exacerbated (see Figure 4). Although the marginal increase in the proportion of funds for capital construction allocated to agriculture in 1958 was accompanied by a moderate increase in output, agricultural production stagnated in subsequent years. To some extent, the drop in agricultural output was precipitated by exceptionally bad weather, but economic reorganization gravely exacerbated problems. In order to achieve or exceed the industrial production targets set out in the national plan, local governments (whose operational mandate was significantly increased during the Great Leap) redirected a large portion of resources and labor from agriculture to the production of iron and other industrial input. The preoccupation with rapid industrialization likewise affected the agricultural communes, so that only some 50 percent of commune workers were actually engaged in agricultural production (Tian 1960). As a consequence, the number of workers employed in industrial units almost doubled from 1957 to 1958 (NBS 2005, table 8). The economic reorganization of the Great Leap greatly aggravated the sectoral imbalances that had

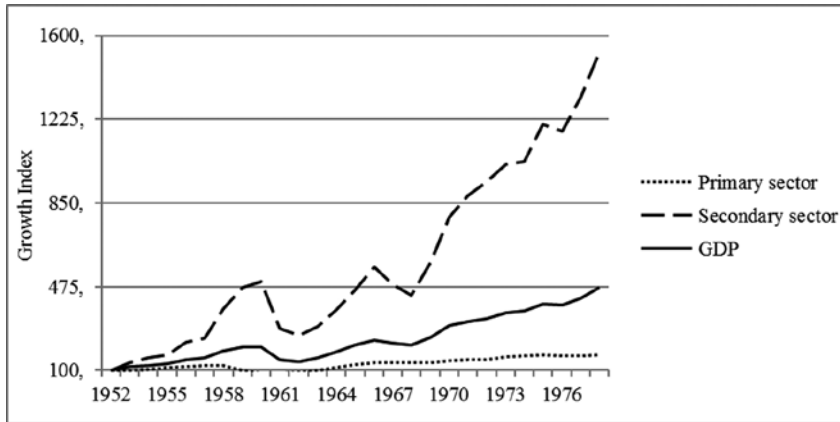


FIGURE 4 *Growth indices of output of primary and secondary industry, 1952–1978.*  
SOURCE: NBS (2005, TABLE 6).

emerged under the First Five Year Plan. Although, in 1957, total output realized in agriculture had surpassed that of industry by some 36 percent, by 1960 agricultural output was 47 percent less than that of industry. Clearly, these figures do not substantiate the proposition that the Great Leap Forward implied the abandonment of the strategy of primitive socialist accumulation in favor of a transition to a more balanced economic strategy of “walking on two legs,” as has been argued by a number of scholars in studies published during and after the Cultural Revolution.<sup>61</sup>

The introduction of liberal policies following the calamity of the Great Leap prompted a temporary shift to a more moderate and balanced pattern of development. Under the banner of “readjustment, consolidation, filling out and raising standards,” adopted in early 1961, all capital construction—save for a limited number of designated priority projects—was called to a halt. Moreover, inefficient newly established industrial enterprises were closed down. By 1961, GFCF dwindled to only 18.7 percent of GDP. Intersectoral adjustments likewise accorded with the new strategy of balanced growth. The transfer of agricultural labor to industry was reversed. In line with the emphasis on the modernization of agricultural production, investment in agricultural capital was also increased, reaching 23 percent of total expenditure on capital construction in 1963. The drive for the technical transformation of agriculture also impacted industry, causing a shift toward the production of agricultural producer goods (Stavis 1978). Due to these policies, agricultural output

61 See, for example, Eckstein (1975); Schurmann (1968); Teiwes (1979); Chesneaux (1979).

rose by 9.8, 12.4 and 16.5 percent respectively from 1963 to 1965. The liberal interlude in policymaking was instrumental in remedying the imbalances of the Great Leap.

However, Mao's return from the second line signaled the reinstatement of radical economic policies unequivocally prioritizing the development of heavy industry. Although efforts at accelerated accumulation were less volatile in the last decade of the Maoist era, by 1978 the proportion of GDP allocated to the formation of fixed capital had nevertheless climbed to a level comparable to that during the Great Leap. In consequence, investment ratios between the first and second economic departments (agriculture and industry respectively) throughout the Maoist era exhibited a much stronger bias toward the development of industry than proposed in the original Fel'dman–Preobrazhensky paradigm. High levels of investment in industry had been supported by the appropriation of agricultural revenues (by way of the so-called price-scissors mechanism, which depressed prices for agricultural produce). Indeed, the strategy of primitive socialist accumulation had caused China's industrial sector to grow by leaps and bounds.

However, the Fel'dman–Preobrazhensky paradigm predicted that improvements in efficiency would eventually cause an upsurge in agricultural production. Such improvements failed to materialize (see Figure 4). Because of the CCP's preoccupation with industrial development, significant expenditure on the production of producer goods for the agricultural sector and investment in the development of basic conditions for agricultural production (irrigation, electrification etc.) had been confined to the period of readjustment in the first half of the 1960s. Rather, the Party had continued to rely on reorganization (i.e. the establishment of large-scale farming collectives) and autonomous investment by the rural community. Although the reorganization of plots into large-scale collectives resulted in labor-saving economies of scale, they had but a marginal effect on overall productivity because rural labor participation had, from the outset, been comparatively low, and there were few alternative uses for idle rural workers.<sup>62</sup> While China's labor force grew by some 191 million between 1952 and 1978, industry only absorbed about 37 percent of this addition (Naughton 2007, p. 81). On the one hand, there was an inherent limit to the extent to which capital-intensive industry could absorb the rural labor surplus. On the other, the covenant between the Party-state and the industrial worker was predicated on the latter's subjugation to the Party-state apparatus in exchange for a comparatively high wage and entitlement to a wide array

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62 The average rate of rural labor participation between 1952 and 1978 was 38.8 percent, and displayed only marginal variation (NBS 1998).

of welfare benefits. Rapid expansion of the industrial workforce would have depressed wages and attenuated the Party-state's capacity for monitoring and control. Thus, the state relied on the household registration system to enforce a stringent constraint on the mobility of rural inhabitants.<sup>63</sup>

The limited capacity of industry to absorb excess agricultural labor was reciprocated by the lack of rural purchasing power, which further prevented the diffusion of industrial products to the agricultural sector. What growth the sector experienced did not result in a commensurate increase of rural affluence; whereas total agricultural output had grown roughly five times between 1952 and 1977 (the year preceding agricultural reform), per capita consumption expenditure had only doubled.<sup>64</sup> Moreover, since production was subject to quota and appropriated by the state at depressed prices, peasants had arguably little incentive to autonomously increase production.<sup>65</sup> Due to the lack of investment in agricultural modernization and limits to the rationalization of the structure of rural labor, production of grain per peasant remained virtually stagnant throughout the plan era, reaching 0.90 cubic meters in 1952 and 0.93 in 1977.<sup>66</sup> In spite of the failure to vitalize agriculture, industry expanded rapidly, growing from around 18 to just under 45 percent of GDP from 1952 to 1978.

Inefficiencies within industry compounded the structural problems of the plan economy. The institutionalized emphasis on accelerated growth coalesced with soft budget constraints, resulting in persistent resource shortage (see Kornai 1980). Moreover, because the CCP sought to ensure fidelity to its leaders and the precepts of communism, the incentives of industrial workers were only partially based on economic achievements. All in all, after nearly three decades of economic development under the Fel'dman–Preobrazhensky paradigm, the Chinese state had failed to achieve the national economic prowess envisioned at the beginning of communist rule.

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63 From the mid-1950s onward, the government utilized an extensive administrative apparatus (the household registration or *hukou* system) to monitor and control all domestic movement of labor. This registration system allowed the government to restrict movement from countryside to city, so as to realize the desired distribution of labor between agriculture and industry. Curbing the inflow of urban migrants was required to ensure appropriate incentives for cooptation of the industrial workforce (Cheng and Selden 1994). Moreover, by preventing the free movement of industrial labor, the registration system provided a prerequisite for the project of sociopolitical transformation, which sought to supplant traditional social relations (of family, region etc.) with ties to the factory or commune (Walder 1988).

64 Calculated from NBS (2005, tables 4, 38).

65 Essentially, the problem was one of rent-seeking, see Murphy, Shleifer and Vishny (1993).

66 Calculated from NBS (2005, tables 4, 39).

Despite repeated calls to depart from the principle of accelerated accumulation in favor of a more balanced trajectory of growth, attempts to adjust the relationship between agricultural and industry in favor of the former were consistently rebuffed by the demagogic politics of the Chairman, whose personal influence in politics was insuperable. The aggregation of authority in the person of Mao, however, also caused the development of a political vacuum after his death in September 1976, enabling Deng Xiaoping to finally introduce the reforms and readjustments that had been debated from 1958 onward. Thus, despite Herculean effort and great expense, attempts to match the accomplishments of the modern industrialized economies within a generation by way of the “productive advantage” of socialist economic organization fell decisively short of the mark. Throughout the era of the plan economy, China maintained a high ratio of fixed gross capital formation to GDP,<sup>67</sup> and the average growth rate of the economy during the period 1952 to 1978 reached 6.7 percent. Although certainly robust, economic growth was nowhere near large enough to realize the objective of matching the productivity of the industrialized capitalist economies within a generation. Nevertheless, through establishment of the material conditions for the development of a modern economy, and by providing the conceptual premises for reform and development, the Maoist era had furnished the requisite conditions for the subsequent development of the socialist market economy (Hung 2016).

### Conclusion

Based on Soviet precedent, the Maoist strategy for economic development followed the principles of primitive socialist accumulation, whereby agricultural commodity production was to furnish the capital for rapid industrialization. Manufacture of production goods would in turn increase the efficiency of agricultural production, so that the absolute levels of output of both the primary and secondary sectors would eventually surpass that realized under a trajectory of balanced growth. As outlined in the preceding section, the strategy of accelerated accumulation fell decisively short of its mark. Observant leaders and economists had already warned about the defects of Chinese economic policy during the period of the First Five Year Plan. Their recommendations comprised two central elements, readjustment (*tiaozheng*) and reform

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67 Ranging from 0.25 in the First Five Year Plan period (1953–1957) to 0.34 during the period of the Fourth Five Year Plan (1971–1975), See Joint SSB-C-Hitotsuhashi Team (1997).

(*gaige*). Initially, discourse emphasized readjustment, that is, the transformation of relations between departments 1 (producer goods) and 2 (consumer goods). Early discussions of reform—relating to the respective roles of the law of value and planned, proportionate development—were, by and large, confined to extending the passive role of exchange values in the planning of commodity production.<sup>68</sup>

Whereas it has been argued that the debate of readjustment gave occasion for Mao to break with the strategy of primitive socialist accumulation in favor of a policy of “walking on two legs” (see Teiwes 1979), the intensification of the expropriation of agricultural output under the Great Leap Forward belies such assertions. From Mao’s writings, we can infer that, in his analysis, the problems of economic development owed nothing to any fundamental flaws in the technical matters of sectoral development or the instruments of allocation, but rather to the underdevelopment of socialist consciousness and the relations of production. By this interpretation, the revolutionary events of the Great Leap Forward and the Cultural Revolution were logically consistent with Mao’s convictions, although disastrous in outcome. However, in the wake of the ideological frenzy and grave economic imbalances of the Great Leap, the discussions on readjustment and reform continued with yet greater intensity. Hence, economists and state leaders sought to overturn the initial prioritization of industry, and extend the role of the law of value in resource allocation. Major advancements along these lines were made in the realm of agriculture between 1960 and 1965. The introduction and subsequent expansion of the policy of *sanzhi yi bao* allowed for the private use of part of farm plots and sale of a portion of produce on the market, and would provide much of the input for Deng’s agricultural reforms of 1978. However, the instigation of the Cultural Revolution brought about a return to Maoist principles. All in all, the basic features of primitive socialist accumulation, that is, a consistently high rate of accumulation and the prioritization of industry over agriculture, predominated within Maoist-era economic development.

The constant juxtaposition of, and contention between, material conditions and consciousness, and productive factors and relations of production in Maoist-era discourse, resulted in an ideological rift between Party and state (Lieberthal 1997). Mao and, in a more general sense, Party leadership had disapproved of the explicit coercion to which Stalin had resorted to further the cause of socialism. Therefore, the emphasis of Party leadership was on the cultivation of socialist awareness through political campaigns and

68 And thus largely consistent the prescriptions provided by Stalin ([1952] 1972).



the reengineering of social relationships. The Party's preoccupation with the eradication of capitalist vestiges clashed with the technical reforms proposed by China's economists, many of whom occupied key positions within the economic bureaucracy or served as advisers to the heads of the central economic commissions. It is not surprising then that once Mao's political attacks on rightism and revisionism abated in the latter years of the 1970s, readjustment and reform became the unequivocal focus of state leadership.

# Market Allocation and Enterprise Reform in the Primary Stage of Capitalism (1978–1992)

## Introduction

During the Cultural Revolution, China's economy once again plunged into crisis. As in the Great Leap Forward, overinvestment by local actors in the last decade of the Maoist era had resulted in grave sectoral imbalances and inefficiencies. Political conditions offered no course for redress; mass movements had paralyzed state leadership and the strong anti-intellectualism of the Gang of Four had precipitated the collapse of China's academic institutions (Kou 2010). Political relations were normalized only after the death of Mao and the overthrow of the Gang of Four in the fall of 1976, allowing the state to formulate a strategy to deal with the economic malaise.<sup>69</sup> The state's response came in the form of a ten-year plan, announced during the first session of the fifth National People's Congress in February 1978. The measures adopted under Mao's appointed successor Hua Guofeng diverged from the Maoist strategy of economic development in their strong endorsement of the "four modernizations" (*si ge xiandaihua*).<sup>70</sup> Notwithstanding the novel emphasis on economic development through the absorption of advanced foreign technology, Hua's plan fell squarely within the remit of the socialist strategy of accelerated accumulation. Investment targets for the final eight years of the plan was to equal the total of the entire past 28 years. A total of 120 large-scale projects were to be constructed and 14 industrial bases were to be developed. In industry, steel production was the "key link"; output was to increase from 30 million tons to 60 million tons by 1985.<sup>71</sup> In short, the new leadership's general strategy for

69 Economic problems had been further aggravated by the devastating Tangshan earthquake in the summer of 1976. As a result, the growth rate of national income dropped by 2.3 percent.

70 The so-called "four modernizations", entailing the modernization of agriculture, industry, defense and science and technology, were first espoused by Zhou Enlai in 1963. Zhou (1980) stressed that the adoption of modern production technology and techniques was crucial to China's development.

71 Hua (1978).

economic development was based on heavy industry-oriented growth (accelerated growth).

Economic growth rates in 1977 and 1978 were impressive at 7.6 and 11.7 percent respectively (NBS 2005, table 8). However, serious industrial bottlenecks were emerging. While Hua Guofeng and the Maoist faction (*fanSHIPai*)<sup>72</sup> contended with the worsening structural problems of the economy, an opposing faction—consisting of leaders advocating sectoral adjustment and those in favor of market reform—was forming. These leaders had been instrumental in formulating and implementing the reform and readjustment policies of the early 1960, which had reinstated economic stability and growth after the disaster of the Great Leap Forward. At the Central Work conference preceding the third plenum of December 1978,<sup>73</sup> Hua suffered a decisive defeat at the hands of the emerging reform faction, allowing Deng Xiaoping to assume the position of paramount leader (Vogel 2011, p. 246). At the plenum Chen Yun was rehabilitated, to become a member of the top Party leadership. The readjustment and reforms subsequently introduced by Deng and Chen Yun marked the beginning of China's trajectory toward market socialism.

Many of the initial reforms introduced under Deng Xiaoping (and accompanying theoretical debate) harked back to the discussions of the liberal interludes of 1956–1958 and especially 1960–1965. However, from the latter half of the 1980s onward, reforms prompted economic developments unaccounted for by these earlier discussions, causing economic discourse to overflow the boundaries of Marxian analysis. Moreover, the expansion of economic theory was accompanied by a reappraisal of the role of economic theory itself. Whereas Mao's emphasis on the socialization of consciousness had implied the subjugation of economic theory to ideology, Deng's unequivocal emphasis on economic development prompted a pragmatist turn. As ideological issues gradually faded into the background (Misra 1998), the concepts of reform and readjustment became the central principles of China's economic paradigm. However, at the same time as these principles drove the development of the socialist market economy, economic and political conditions caused a bifurcation of the reform and readjustment programs, which had initially been

72 Hua and his conservative supporters were referred to as the *fanSHIPai* "lit. two whatever faction," because of their insistence on "persisting in the conservation of whatever policy chairman Mao implemented, and; unwaveringly respecting whatever instructions Chairman Mao issued." See *Renmin Ribao* (1977).

73 The third plenum of the eleventh Central Committee of the CCP is of particular importance because it was at this session that the policies for the subsequent planning period were set out.

regarded as natural complements, straining the alliance between Deng and Chen Yun.

### The Pragmatist Turn and the Liberalization of Economic Discourse

The reforms introduced by Deng some 20 years after their initial conception in the 1950s and early 1960s were made possible only by a fundamental change in ideology. Marxist–Leninist doctrine held that socialist development depended on the comprehensive transformation of both the productive forces and the relations of production. Of these two conditions, Mao had consistently prioritized the latter. Efforts to achieve the socialization of consciousness reached their zenith during the last decade of Mao’s rule. The Cultural Revolution, seeking to bring about a classless society and abolish the law of value, amounted to a repudiation of all theory of productive forces (i.e. the technical study of economic efficiency), of intellectualism and finally of the method of science itself (Lin 1981). Brock relates that, through mass experimentation, certain advances in production methods and technology were made (2009). However, it is indisputable that the Cultural Revolution on the whole seriously hampered the progress of Chinese economic practice and theory. Managerial positions within enterprise were abolished, and much economic planning suspended. The majority of academic institutions were closed, publication of major research journals ceased, and scholars and state leaders who had maintained “revisionist” opinions were sent to the countryside for ideological rectification, or imprisoned.

Following the heydays of the Cultural Revolution, Deng labored to normalize governance and politics,<sup>74</sup> reinstate the managerial supervision of production and the policy of “to each according to one’s labor” (*an lao fenpei*),<sup>75</sup> and promote economic modernization.<sup>76</sup> This pitted him against the Gang of Four, who, after the dissolution of the Small Leading Group for Cultural Revolution

74 Deng himself had been ousted from government in 1969. However, Zhou Enlai’s support, against the backdrop of worsening economic imbalances in the 1970s, allowed Deng to return to state affairs in 1973.

75 The concept of “to each according to one’s labor” stood in opposition to the capitalist distributive principle of “to each according to one’s capital” (*an zi fenpei*).

76 In 1975, Zhou had once again proposed his four modernizations, arguing that science and technology constituted the “major productive force,” “Zhou Enlai zai si jie da hui baogaozhong chongshen ‘si ge xiandaihua’” (1975). Deng strongly supported Zhou’s efforts. For this and subsequent documents concerning the proceedings of the National People’s Congress see <<http://cpc.people.com.cn/GB/64162/64168/index.html>>.

(*wenhua da geming lingdao xiaozu*) in 1969 (McFarquhar and Schoenhals 2006), had become the de facto representatives of the radical faction within Party-state leadership. Blaming Deng for the popular unrest following Zhou Enlai's death in 1976, the Gang of Four launched the anti-Deng campaign (Dietrich 1998). A special report in the *People's Daily*, commenting on Deng's proposals on the reorganization of Party, and industry and science,<sup>77</sup> argued that "[these proposals] reflected Deng's anti-revolutionary and revisionist character. . . . [They] are ironclad proof of the continuing existence of capitalist roaders" (Hongqi 1976).

These condemnatory criticisms prevented Deng from assuming the role of paramount leader upon Mao's death in September 1976. Rather, that position was bequeathed to Hua Guofeng, who was ideologically close to Mao. Hua—while declaring the Cultural Revolution a victory for the Chinese people—was, however, quick to denounce the Gang of Four, who were contending the state leadership's political authority. Jiang Qing and her associates were arrested in October 1976. Political and public discourse in the subsequent period strongly repudiated radical rhetoric. In the wake of the turmoil and economic imbalance of the Cultural Revolution, the role of ideology within governance also became the subject of intense debate. In May 1978, *Guangming Ribao* published an essay at the behest of Party leadership. The piece commented that through their manipulation of public opinion, the Gang of Four had obfuscated objective measures of truth. Subsequently, people should no longer recourse to rhetoric or theorizing without empirical foundation. "Practice," stated the author, "is the sole criterion of truth." The epistemological perspective adopted by the state claimed to constitute a "liberation of thought" (*sixiang jiefang*) removed from the stringent ideological constraints of the Cultural Revolution and allowing for the continuation of the discussion on the law of value and the role of market allocation, which had been suspended for a decade.

Although, in the late 1970s, reforms and readjustment were once again topics of fervent debate, many leaders and academics continued to resist notions of decentralization and market allocation on grounds that such policies stood in direct opposition to the principles of socialism. In an address to the fourth meeting of the fourth plenary session of the eleventh Central Committee, Ye Jianying—who at the time served as chairman of the Standing Committee of the National People's Congress—charged that the Gang of Four had "completely

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77 The documents in question are "Lun quan dang guan guo ge xiang gongzuo de zong-gang" (1977); "Guanyu jiakuai gongye fazhan de ruogan wenti" (1977)]; and "Zhongguo kexueyuan gongzuo huibao tigang" (1977), jointly referred to by the Gang of Four as the "three poisonous weeds."

inverted the relationship between subjectivism and objectivism, consciousness and material conditions and grossly exaggerated the revolutionary function of socialist consciousness in the development of society; of the superstructure in establishing the economic foundation;<sup>78</sup> and of the productive relations in developing the productive forces.” While China had already established the basic features of socialism, Ye stated, both economy and society remained underdeveloped (Ye 1979). In June 1981, the CCP officially endorsed the concept of the “primary stage of socialism” (*shehui zhuyi chuji jieduan*), stating that “the completion of the socialist system would be a tortuous process.”<sup>79</sup> By emphasizing that the trajectory toward socialism would be long and arduous, the Party-state refuted the possibility of achieving the transition through revolutionary means. Rather, the development of the productive forces was the primary condition for the realization of socialist society. As a result, the transition of power from Mao to Deng was paired by a gradual shift in emphasis within the economic paradigm from the socialization of consciousness to the development of material conditions.

Ironically, it seems unlikely that this reversal in prioritization of the social and technical factors, and the abolishment of the Maoist principle of continuous revolution, would have been possible without the Gang of Four. The gang’s actions in the first half of the 1970s weakened support for the radical faction and caused mounting popular dissent, creating the political scope for reform and readjustment. Moreover, the gang’s role in the Cultural Revolution allowed Deng and other reform-minded leaders to denounce the politics of mass struggle without directly criticizing Mao.

## Early Reforms and Readjustment (1978–1986)

### *Chen Yun’s Reforms Vindicated*

The vindication of state leaders and economists who had championed reforms in the Maoist era, allowed for the proposals outlined by Chen Yun some two decades earlier to be reintroduced in academic and policy discourse. Issues of price formation and the law of value were once again intensely debated. Hu Qiaomu, president of the Chinese Academy of Social Sciences (*zhongguo*

78 In Marxian theory, the “superstructure” refers to the political system, institutions and culture, i.e. those elements of society that are not directly pertained with, but nevertheless play an indispensable supportive role in economic production. See the preface to Marx (1904).

79 “Guanyu jianguo yilai dang de ruogan lishi wenti de jueyi” (1981).

*shehui kexueyuan*), voiced his strong support for the expansive operation of the law of value in an article in China's leading newspaper *People's Daily* (Hu 1978). In a refutation of Stalin's insistence on limiting the operation of the law of value to the sphere of national accounting, Hu argued that rational economic planning could only be achieved by allowing the law of value to exert its regulatory function in price formation. He furthermore insisted that the supposition that the laws of value and planned proportionate development were antagonistic was erroneous. What separated capitalist economies from their socialist counterparts was not the existence of the law of value, but rather the spontaneous and anarchistic operation thereof. Hu's perspective resonated with many of China's prominent economists (Liu, G. 1980; see Liu and Zhao 1979; Sun 1979, pp. 346–370) and policymakers.

In line with Chen Yun's proposals, experimentations with market allocation focused initially on the rural economy. The household responsibility system (*jiating lianchan chengbao zerenzhi*), introduced on a trial basis in 1979, allowed farmers to retain and sell for a profit any output above state-contracted quota. Introduction of the household responsibility system also allowed peasants to engage in non-agricultural production, providing a means to alleviate the problem of idle rural labor. By way of the 1979 "Decision on Certain Issues regarding Accelerated Agricultural Development," central government explicitly endorsed and encouraged the development of so-called township and village enterprises (TVEs, *xiangzhen qiye*). However, the expansion of TVEs was primarily driven by peasants and local government. Localities had been given authority to tax TVE sales and retain fiscal revenue beyond a negotiated proportion remitted to the center. As a result, local government acquired a strong interest in the fortunes of the TVEs (Chang and Wang 1994; Kung and Lin 2007). Since the emphasis under Mao had been on the development of heavy industry, bureaucratic interest in the agricultural sector was marginal, and therefore agricultural reforms met with little resistance (Shirk 1993). However, within public industry resistance to market reforms was considerable. As a consequence, within public industry prices continued to be determined by plan.

The debate concerning the decentralization of financial responsibility to enterprise resurfaced in tandem with the discussion of price formation and the law of value. Early proposals advocated the devolution of financial and operational authority to the industrial workforce (Dong 1979; Jiang 1980). The notion of collective management, however, failed to gain widespread support, as policymakers feared that workers would lack the requisite expertise. Rather, the state promoted the view that financial rights and responsibility ought to be invested in enterprise. Accordingly, management would be accountable for enterprise profits and losses and would be allowed to independently

allocate its funds and engage in exchange (Hsu 1989).<sup>80</sup> Experimentation with the extension of managerial authority commenced in the fall of 1978. By the fall of 1980, 6,600 enterprises throughout the country, roughly accounting for 60 percent of industrial output, were granted the so-called “eight rights” of the Sichuan “experiment” (Tian 1981). This policy allowed SOEs to retain part of their profits, which could be used to fund the expansion of production. Enterprises were also allowed to engage in market production, provided they fulfilled stipulated quota, and were eligible to engage in the sale and purchase of products on international markets. Finally, enterprises were given greater discretion in their dealings with the workforce, and could issue individual bonuses to reward excellent performance or fire workers in case of grave misconduct (ibid.).

### *Opening Up: China's Special Economic Zones*

While, within discussions on economic development, emphasis was on readjustment and reform, opening up (*kaifang*), that is, the reestablishment and expansion of international trade relations, constituted another major part of Deng's initiatives. The most salient representation of the strategy of opening up was arguably the development of the special economic zone (SEZ) (*jingji tequ*). Throughout the 1980s, a number of coastal cities and the province of Hainan were designated as sites with expanded autonomy for Chinese enterprises and preferential conditions for foreign investors. Two factors spurred the conception of these SEZs. First, the zones were to be employed as a testing ground for reform policies (Xu 1981). Self-contained and effectively insulated from the main body of the Chinese economy, the zones would allow the Chinese state to appraise the implications of greater enterprise autonomy and the liberalization of production and trade in both manufacturing and services. In choosing relatively remote and underdeveloped areas, the potential downsides of such experimentation could be easily contained (Heilmann 2008).<sup>81</sup> The immediate motivation for the introduction of the SEZs, however, was provided by the objective of industrial modernization. In the 1950s, Mao had argued that socialist industrialization could not be realized by relying on the

80 The notion of investing financial accountability in enterprise was not without its detractors. Economists such as Jiang Xuemo argued that, without the completion of price rationalization, the transfer of financial authority to enterprise would not promote the efficient utilization of capital; see Hsu (1989).

81 It has been maintained that subsequently a pattern emerged wherein local experimentation preceded national policymaking, accounting for the incremental quality of reforms, see Heilmann (2008); Qian, Roland and Xu (2006).



transfer of advanced production technologies and methods from imperialist nations, and that it was necessary to adopt a strategy of self-determination and self-reliance (*duli zizhu, zili gengsheng*) (Mao 1992, p. 273). After the Sino-Soviet split in 1960, China's inward orientation intensified, although Zhou Enlai repeatedly objected to China's self-imposed exile from the international economy (Zhou 1997, p. 226). Following the heyday of the Cultural Revolution (lasting from 1966 to 1969), Zhou was able to push forward the development of export commodity production bases, which came to serve as a precedent for Deng's SEZs (Stoltenberg 1984). However, up until the defeat of the radical faction in 1978, the antipathy toward international trade continued to prevail. As a result, Chinese industrialization during the Maoist era had to rely on comparatively backward technology.

This changed during Hua Guofeng's interregnum, when the "four modernizations" began in earnest. From July to September 1978, the issue of the rate of modernization was intensively discussed. State leadership concluded that a new Great Leap was required in order to rapidly improve the productivity of Chinese industry. Accordingly, within the Ten Year Plan, major outlays were made for the central procurement of foreign, advanced production technology (Li 2007). The strategy was not met with unequivocal approval. Certain economists and state leaders considered reliance on the import of turnkey installations imprudent. They argued that an emphasis on large-scale construction of new capital would aggravate sectoral imbalances. Moreover, it was wondered whether new technology could be effectively absorbed so as to ensure a commensurate upturn in productivity (Lin 1981). Chen Yun insisted that the modernization of industry ought not to rely on a small number of massive projects, but should rather focus on a comprehensive reorganization and technological transformation of extant production capacity. Indeed, central outlays for newly installed modernized production capacity were significantly scaled back the following year.

It was within the context of technological transformation under conditions of decreased central spending on capital construction that discussions regarding the SEZs emerged. Two diverging conceptions were initially put forward. The first—a relatively straightforward extension of the commodity production bases of the early 1970s—sought to emulate the export-oriented model of industrialization that had been adopted in, amongst other countries, Japan and South Korea in their initial stages of development. Concentrated in relatively developed economic areas, these zones would focus on exploiting their labor cost advantages in the manufacture of commodities that could be traded for advanced technologies on the international market (Wong 1987). The second conception sought to stimulate industrial modernization through

the attraction of foreign capital and technology. Through joint production, Chinese firms would be able to access advanced production methods and equipment. Moreover, increased foreign investment would expedite industrial modernization while relieving the fiscal burden of the central state. Searching for a model that could advance both industrial modernization and promote the reform program, Deng Xiaoping ardently supported the latter perspective.

In July 1979, the administrators of Guangdong and Fujian province jointly drafted a proposal for the establishment of a SEZ in Shenzhen and Zhuhai, with another two such zones to be established in Shantou and Xiamen pending evaluation of the initial outcomes.<sup>82</sup> In August of the following year, the State Council issued standardized regulations for the Guangdong SEZs. The central state would be directly responsible for the administration of the zones, but would for the most part refrain from interfering in production and trade. Foreign enterprises operating in the zones could engage in direct investment or joint ventures with Chinese enterprise. These firms would enjoy a variety of preferential conditions, such as: (1) reduced prices for land; (2) lowered enterprise and output taxes—with additional reductions for firms making large or long-term investments or producing high-tech goods—and (3) preferential pricing for Chinese raw materials or machinery.<sup>83</sup>

Plans for establishing SEZs also included the island of Hainan, which at the time was administratively part of Guangdong province (Brødsgaard 2009). Since Hainan, compared to the other zones, comprised a much larger area—only slightly smaller than Taiwan—these plans were potentially even more far-reaching than the decision to establish four other zones in Shenzhen, Shantou, Xiamen and Zhuhai. In order to discuss ways of bringing Hainan's future development into line with general reform and open-door policies, a conference on the so-called Hainan Island Problem was held in Beijing in June–July 1980. The conference was called by the State Council and included leading officials from Guangdong province and Hainan administrative region as well as from a number of central ministries and commissions such as the State Agricultural Commission and the Ministries of Agricultural Reclamation, Forestry, Water Resources and Electric Power, Civil Affairs, Finance and Communication. Top leaders such as Zhao Ziyang, Wan Li, Gu Mu and Bo Yibo took part in the conference and issued “important instructions.” According to the State Council's summary of the meeting (henceforth known as “circular 202”), it was decided to grant Hainan more autonomy in the area of foreign

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82 “Guangdong shengwei he Fujian shengwei guanyu duiwai jingji huodong shixing teshu zhengce he linghuo cuoshi de baogao” (1979).

83 “Guangdong sheng jingji tequ tiaolie” (1980).

economic activities. The island was to retain a certain percentage of foreign exchange earned and to be permitted “relatively large jurisdictional control.”<sup>84</sup> It was specifically mentioned that Shenzhen’s and Zhuhai’s experiences could be used as a reference for Hainan’s future development. In sum, a number of measures and policies were to be adopted in order to expand local economic autonomy. Some of these measures addressed the need to stimulate Hainan’s backward agricultural sector; others dealt with foreign economic issues and resembled earlier initiatives taken in Shenzhen and Zhuhai SEZs.

Provincial officials in Guangdong also supported the idea of giving Hainan more autonomy and possibly developing a new SEZ on the island. Ren Zhongyi, who had replaced Xi Zhongxun as first Party secretary of Guangdong, was particularly in favor of accelerating the economic development of Hainan.<sup>85</sup> In November 1981 the Party committee of Guangdong issued a circular (*yuefa*), which stipulated the adoption of preferential measures in Hainan vis-à-vis foreign joint ventures, such as a tax holiday, low prices in connection with rental of land and buildings, advantageous procedures by import of production materials, retention of foreign exchange, cheap labor power and so on.<sup>86</sup> This was believed to greatly facilitate the inflow of foreign direct investment (FDI). As one local official explained in 1982: “We can even offer better terms than in Shenzhen. In joint ventures we can provide cheaper labour power and land than Shenzhen” (Brødsgaard 2009, p. 16).

However, local officials’ attempts to turn Hainan into an SEZ similar to Shenzhen were thwarted by conservative leaders in Beijing. They did not object to Guangdong province allowing Hainan more autonomy, but they hesitated to go all the way and formally declare Hainan an SEZ. In fact, key leaders such as Chen Yun and Li Xinnian had all along expressed reservations concerning the zone policy. They were not ready to support the establishment of yet another zone, which, in terms of geographical size and population, would dwarf those that the center had already decided on. However, in 1983, Zhao Ziyang, supported by Deng Xiaoping, was able to push the Party Central Committee and the State Council to issue a new circular on Hainan’s development. The circular specified the powers the center and Guangdong province were prepared to give Hainan in areas concerning direct foreign investment and the establishment of joint ventures with foreign participation. In general, Hainan acquired all the autonomy in foreign trade and investment that had earlier been given

84 “Hainan dao wenti zuotanhui jiyao” (1980).

85 This section on establishing a SEZ on Hainan builds on Brødsgaard (2009).

86 “Zhonggong Guangdong shengwei, Guangdong sheng renmin zhengfu guanyu jiakuai Hainan dao kaifa jianshe jige wenti de jue ding” (1985, pp. 103–119).

to Shenzhen and the other SEZs, although the island had not yet formally been declared such an entity. It had become a “*bu shi tequ de tequ*,” a special zone which is not a special zone (Li and Zhu 1988). Clearly it was only a matter of time before Hainan would be declared a SEZ in name, similar to the other four zones established in 1980.

However, corruption and especially the so-called “Hainan car scandal” shattered the dynamism of the Hainan reformers and gave the conservatives good arguments for slowing down the process. The establishment of the SEZs raised concerns among conservatives, who believed that market-based production and exchange within the SEZs undermined the socialist character of the Chinese economy. Moreover, they charged that, by allowing foreign enterprises to appropriate part of the surplus value of Chinese labor, the SEZs had brought about a novel form of imperialism. Skeptics of the establishment of SEZs could draw on powerful support, especially from Chen Yun and Li Xiannian, who indicated their reservations by never visiting any of the zones. Proponents of the zones, however, argued that the operations of foreign enterprises operating within the zones were subject to administration by the Chinese state, and thus constituted a regulated form of state capitalism. Since the exchange between these foreign enterprises and Chinese firms was based on principles of equality and self-determination, concerns regarding imperialist expropriation were deemed unfounded (Xu 1981). Proponents of the zones were supported by Zhao Ziyang and Hu Yaobang and especially Deng Xiaoping. They believed that the rapid expansion of the SEZs would not only advance industrial modernization but could also promote the reform program by providing a testing ground for reform policies (Xu 1981). Self-contained and effectively insulated from the main body of the Chinese economy, the zones would allow the Chinese state to appraise the implications of greater enterprise autonomy and the liberalization of production and trade in both manufacturing and services. In choosing relatively remote and underdeveloped areas, the potential downsides of such experimentation could be easily contained (Heilmann 2008).<sup>87</sup> In the early 1980s, the state forged ahead with the establishment of SEZs in Shantou and Xiamen, and the Seventh Five Year Plan (1985–1990) designated the coastal SEZs the beachhead of economic modernization.<sup>88</sup>

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87 It has been maintained that subsequently a pattern emerged wherein local experimentation preceded national policymaking, accounting for the incremental quality of reforms (see Heilmann 2008; Qian, Roland and Xu 2006).

88 “Zhonghua renmin gongheguo jingji he shehui fazhan diqi ge wu nian jihua (zhaiyao)” (1986).

In 1984 it was decided to give 14 cities along the coast the status of so-called “open cities.”<sup>89</sup> Special policies were introduced to attract foreign investment, although the open cities never obtained the full package of preferential policies that the four SEZs were granted. In mid-1987, Deng divulged, in a discussion with a Yugoslavian delegation, that he intended to push forward with the idea of developing Hainan into an official SEZ (Brødsgaard 2009).<sup>90</sup> Subsequently, the State Council suggested that Hainan should no longer be part of Guangdong province but should be granted the status of an independent province, and fiscal and operational responsibilities would be decentralized accordingly. This implied, first, that enterprises in Hainan directly administered by the center or by the provincial authorities of Guangdong province were to be taken over by the new Hainan provincial government, although the center would continue to offer support in terms of investment, subsidies and raw materials. Importantly, plans for the further development of Hainan’s economy would be required to be financed through Hainan’s own resources and foreign investment, and not by increased investment from the center. Government intervention in foreign investment and development of an economic sector with foreign participation would be reduced even beyond that in the other SEZs. Indeed, under the auspices of Deng, Hainan was to become a testing ground and model for regional and bureaucratic reform for the whole country (*quanguo sheng yiji jiegou quanmian gaige de shidian danwei*).<sup>91</sup> Although the Tiananmen debacle would momentarily detract from the emphasis on reform and opening up, in 1992 the SEZs would once again invigorate the reformist drive for decentralization and internationalization.

### *Readjustment*

While reform of the mechanisms of allocation and the administration of enterprises eventually became the dominant theme in the era of Deng, and China’s gradual integration into the international economy would have global implications, the more immediate concern in the initial post-Mao period was with the adjustment of the investment ratio and sectoral redistribution. Hua’s

89 The 14 open cities were Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai (Brødsgaard 2009, p. 33).

90 Yugoslavia was of particular interest to China’s reformist leaders and economist because it had embarked on a course of socialist market reforms as early as the 1950s.

91 See “Zhonggong zhongyang, guowuyuan guanyu jianli Hainan sheng ji qi choujian gongzuo de tongzhi—zhongfa 23 hao, 1987” (1998, pp. 7–10).

economic policies had perpetuated the Maoist-era pattern of accelerated accumulation, and the majority of government outlays had been allotted to projects in heavy industry. Additionally, between 1976 and 1978, the rate of gross fixed capital accumulation had climbed to an average 29 percent. The third plenum, held in December 1978, issued a comprehensive set of policies that sought to ensure a decisive break with the Fel'dman–Preobrazhensky model. A first host of policies focused on the attenuation of the price scissors. First, government procurement quota of grain would remain at the level of the period 1971–1975. Moreover, the prices at which government procured agricultural commodities were increased by an average 22.1 percent, and the price for the amount purchased above the quota by an additional 50 percent (Lin 1992). At the same time, prices for agricultural producer goods (machinery, fertilizer and pesticides) were reduced by some 10 to 15 percent between 1979 and 1980.

In addition to the attenuation of the price scissors, preparations were made to significantly decrease and redistribute investments in capital construction. An editorial in the *People's Daily* announced that this would imply a scaling down of capital construction, primarily involving the iron and steel sector of heavy industry (*Renmin Ribao* 1979). At the conference for national capital construction in March 1979, the decision was made to terminate any industrial project that had been initiated without ensuring adequate supplies of capital and labor or fell short of central technological, environmental and efficiency-related criteria. Thus, only a fraction of the 120 large-scale projects detailed in the Ten Year Plan were to be completed by 1985 (the timeframe set out originally). Besides excessive and careless investment in heavy industry, the inefficacy of the strategy for economic modernization was attributed to the neglect of basic infrastructure. Therefore, the director of the State Capital Construction Commission, Han Guang, pledged to use a greater proportion of funds for the development of construction, transportation and energy (State Statistical Bureau 1979).

Although these measures proved successful in reducing budgeted funds for capital construction, they had but a marginal influence on the overall pattern of accumulation (see Table 4). The problems in achieving sectoral adjustment were largely due to decentralization. The “eight rights” policy had allowed enterprises to autonomously engage in the expansion of production capacity. Moreover, the devolution of operational authority to enterprise had diluted the influence of local government and had therefore met with strong resistance. Reforms had only been able to proceed through a *quid pro quo* where the loss of local authority over enterprise had been compensated by increasing provinces' discretion in raising and allotting fiscal revenues (Shirk 1990). Local

TABLE 4 *Capital construction and GFCF as a percentage of GDP, 1978–1985*

	Central state investment in capital construction/GDP	GFCF/GDP
1978	12.47	29.46
1979	10.99	28.38
1980	7.67	29.09
1981	5.30	27.38
1982	5.08	28.24
1983	5.80	28.90
1984	6.30	29.79
1985	6.17	29.64

SOURCE: CALCULATED FROM NBS (2005, TABLES 6, 10, 18).

government and SOEs used their increased financial prowess to fund the expansion of productive capacity. Increased industrial investment by local government and enterprise offset reduced central expenditure on capital construction, so that the rate of GFCF remained essentially unchanged (see Table 4).

The initial departure from the Fel'dman–Preobrazhensky paradigm of accelerated industrialization had been made possible through a coalition of proponents of sectoral readjustment and advocates of decentralization and market allocation.<sup>92</sup> However, readjustment and reform proved incompatible; decentralization of fiscal power frustrated central attempts to adjust sectoral relationships or influence the rate of accumulation. Deng's policies had followed the guidelines for reform and readjustment set out in the economic discourse of the late 1950s and especially the early 1960s. Those discussions had not anticipated the antagonism between decentralized investment and the development of agriculture. Nor had they considered the conjunctural problems that attended market-driven investment. Accordingly, in the early 1980s, the long-standing debate on sectoral relations and the rate of accumulation

92 As reflected in the new official shibboleth of economic policy adopted in 1978: "readjustment, reform, consolidation and improvement" (*tiaozheng, gaige, zhengdun, tigao*), thus substituting the previous focus on the concentration of control with one on decentralized allocation.

ushered in a comprehensive reevaluation of the respective roles of regulation by central plan and market allocation.

*Reform and Recentralization, Balanced and Accelerated Growth*

The antagonism between the goals of readjustment and reform aroused considerable debate among Chinese policymakers and economists. An influential piece in the Chinese daily *Guangming Ribao* stated that the traditional strategy of accelerated accumulation had been characterized by low efficiency and had failed to significantly raise the standard of living (Pei, Liu and Li 1980). For example, according to the *Guangming Ribao* article, per capita grain consumption was 205 kilograms in 1956, but in 1978 it had actually dropped by 10 kilograms. Per capita average consumption of cotton cloth had remained stagnant, totaling 8.3 square meters in 1956, and 7.6 square meters in 1978. Moreover, a 1978 urban survey showed that per capita housing floor space was only 3.6 square meters. A special commentator's report in the *People's Daily* noted that the diversification of investment channels had contributed to excessive and uncontrolled accumulation in industry. Accordingly, adjustment of the rate of accumulation and the relationship between industry and agriculture could only be realized by consolidating central control over capital construction funds, the allocation of raw material and financial capital, that is, a partial reversal of reforms (*Renmin Ribao* 1980). The detrimental outcomes of uncoordinated accumulation bolstered the demands for recentralization by the more conservative leadership associated with the State Planning Commission. In February 1981, State Council declared that all investment in capital construction ought to be included within the government budget and was to be supervised by the Capital Construction Bank of China.<sup>93</sup> Additional measures were announced in spring 1981. The central state was to significantly expand its control over capital construction, banking and taxation, material supplies and pricing (Yao 1981).<sup>94</sup> The extensive remit attributed to the central state was deemed necessary to deal with the rapid increase of extrabudgetary funds, which constituted a primary source of industrial investment.<sup>95</sup> The consolidation of fiscal control indeed allowed the center to finally push forward

93 *Xinhua News* (February 3, 1981).

94 Yao Yilin had assumed the position of director of the State Planning Commission in March 1980.

95 In fact, fiscal control had already been significantly decentralized from the Great Leap Forward onward; from 1959 to 1978, local government controlled an average 84.5 percent of state revenue. However, following the reforms, extrabudgetary revenues (over which



the readjustments that had been a focal point of economic policy from 1978 onward. By the end of 1981, the output of agriculture and light industry had grown by 5.7 and 14.1 percent respectively. Heavy-industrial output, by contrast, had contracted by 4.7 percent. In tandem, the rate of GFCF was steadily decreasing.

The changing pattern of economic development was not, however, met with unequivocal approval. From the outset, Deng's policies of readjustment and reform had been opposed by conservative leaders and scholars. They remained of the opinion that economic development depended on the accelerated growth of the producer goods sector (Liu 1979). To support their argument, proponents of accelerated industrialization pointed out that the contraction of heavy industry had been accompanied by a decline in overall economic growth.<sup>96</sup> While acknowledging the importance of agriculture, light industry and industry, economists like Zhou Shulian and Wu Jinglian reiterated the Maoist-era view that their development could only be realized through the manufacture of producer goods for these sectors (Zhou and Wu 1981). Further constraints on the rate of accumulation and the growth of heavy industry would result only in "recession and economic stagnation" (Liu, P. 1982, p. 29; Sun 1982).<sup>97</sup> The development of industry was hampered not only by the renewed emphasis on agriculture, but also by the myriad fiscal measures introduced after 1979 to supplement household incomes. Subsidies on food, housing and welfare between 1979 and 1981 totaled 62.8 billion yuan or about 20 percent of state revenues realized in that same period. Increasingly, economists advocated that the growth of consumption would be kept below the rate of growth of GDP (Liang and Yang 1982). Dong Fureng, writing in *Caimao Jingji* (*Finance & Trade Economics*) in April 1982, claimed that it was correct to stress the development of light industry and agriculture at present. However, in his opinion, "There is no doubt that the growth of light industry cannot be permanently higher than that of heavy industry and that the slowdown of heavy industry should not continue indefinitely" (Dong 1982, p. 12). His reasoning

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the center exerted no control) rose rapidly, equaling 51 percent of budgeted state income by 1981 (NBS 2005, table 23).

96 In 1981, the growth rate of GDP had fallen to 5.2 percent, 2.6 percent below the previous year (NBS 2005, table 8).

97 Others took an intermediate position. In their perspective, "reducing heavy industrial output is only a temporary measure, and allowing light industrial output to grow faster than heavy industrial output also must not be instituted as long-term policy" (Liu and Liren 1981, p. 7; see also Dong 1982).

was that, in the long run, a high growth rate in light industry cannot be sustained without priority being given to the development of heavy industry. In *Jingji Yanjiu*, in May 1982, Sun Shangqing criticized the view of stressing, in a one-sided way, improvement of the people's standard of living and neglecting capital construction as being "erroneous in theory and harmful in practice." Although it had been necessary to improve the income level of the population "several years ago," it was impossible to realize such a large increase year after year because that would affect necessary capital construction. Consequently, the consumer goods sector should not always be assigned top priority: "During a certain period and under certain conditions heavy industry must be assigned priority in economic development" (Sun 1982). In sum, from late 1981 onward several of China's leading economists would increasingly question official readjustment policies. They were clearly worried about the downward trend of heavy-industrial production and what seemed to be too large increases in consumption levels with negative effects on necessary capital construction.

However, unanimous agreement was not reached. The October and November 1982 issues of *Jingji Yanjiu* carried articles arguing that agriculture was still the strategic pivotal point in economic development. Wang Songpei and Qiao Tongfeng stressed that overall economic growth depends on the agricultural surplus (surplus labor) supplied by the peasants after having fulfilled their own needs. They admitted that the modernization of agriculture requires the support of technical equipment from industry, but "in the final analysis the modernization of industry and industry's rapid development depend on a firm foundation of a rapidly developed agriculture" (Wang and Qiao 1982). Not surprisingly, they also favored "a speedy rise" in the income and standard of living of the people, especially the peasants. Zhang Zhouyuan claimed that in 1981, when heavy-industrial production dropped, "some people" overestimated the seriousness of the problem and "said that the national economy was withering" and "even set the development of heavy industry against that of agriculture and light industry just because readjustment over the past two years slowed down the growth rate of heavy industry, particularly in the machinebuilding industry" (Zhang 1982). Agriculture remained the foundation or rather "the primary strategic task" in economic development. As to the relationship between heavy industry and light industry, a strategy of making the rate of development of light industry surpass that of heavy industry should still be applied. In sum, although advocates of a rise in heavy-industrial production and increases in investment seemed to be in the majority, proponents of a development strategy stressing the strategic role of the consumer goods sector (light industry and agriculture) were by no means silenced.

*The Sixth Five Year Plan (1981–1985): From Plan Economy to Macro-control*

Throughout 1982,<sup>98</sup> state leaders labored to devise a definitive strategy for economic development under the period of the Sixth Five Year Plan. In January, Chen Yun convened leading cadres within the State Planning Commission to discuss the appropriate roles of plan and market allocation. All parties agreed that China's economy ought to be regulated by some combination of central planning and market allocation. Devolution of fiscal and operational authority was believed to incentivize enterprise and improve responsiveness to local demand and supply conditions. However, the economic imbalances of the Great Leap, Cultural Revolution and the overaccumulation of the early 1980s, it was argued, constituted proof that overall departure from the principle of planning would be detrimental to economic development (Xiang, Zhang and Tian 1982). In defining the respective scope of plan and market, the majority insisted on adhering in principle to the boundaries first proposed by Chen Yun in 1956:

[T]he backbone enterprises [constituting] the national economic lifelines and major products must be included in national planning;<sup>99</sup> the major proportions within the national economy must be strictly controlled through national planning[.]<sup>100</sup> At the same time, we must fully utilize the supplementary instrument of market allocation; and the production and exchange of the many diverse commodities that are unsuitable for unified planning can—within the boundaries of the plan—be organized according to changes in market supply and demand.

GONG AND XU 1982, P. 8

An important framework for the debate at the time was Chen Yun's statement that the relationship between the market and the plan was similar to the relationship between a bird and a cage (Brødsgaard 1991). The plan is the cage and the market is the bird in the cage. According to Chen Yun, if the cage was too small or too tight, the bird could not move and would suffocate. But if there is no cage, the bird would fly away. In practice the bird was given more freedom

98 Although the plan nominally covered the period 1981 to 1985, it wasn't in fact actually completed until December 1982.

99 The national economic lifelines (*guojia jingji mingmai*) are comprised of heavy industry, energy and transportation.

100 The major proportions were those between capital accumulation and consumption, agriculture and industry, and light and heavy industry; see Su (1982).

than Chen Yun thought acceptable. According to Xue Muqiao (1982) effective simultaneous operation of planned and market allocation would hinge crucially on the utilization of “economic levers” (*jingji ganggan*), that is, indirect measures by which the state could influence supply and demand. The rationale for relying on economic levers was twofold. On the one hand, as the technical and ideological conditions of socialism were still far from complete, it was considered unfeasible to engage in comprehensive planning. On the other, without central guidance, decentralization would cause deviation from plan targets (Xiang, Zhang and Tian 1982). The primary economic lever comprised a system of disaggregated prices. Scarce or crucial economic inputs (e.g. energy and major producer goods) would be subject to fixed planned prices (*guding jiage*). Prices for certain major commodities would be allowed to float within a centrally stipulated minimum or maximum (*fudong jiage*). Certain agricultural products and output of TVES would be priced on the basis of periodic contracts (*yigou jixiao jiage*). The price of remaining commodities would be determined on basis of market demand (*jishi maoyi jiage*), and would not be subject to any restrictions (Su 1982).

The use of price controls, it was argued, amounted to the conscious manipulation of the law of value in order to regulate supply and demand and maintain overall economic balance (Gong and Xu 1982). Accompanying fiscal measures were to ensure that price controls would not adversely affect enterprise performance: “[We] must ensure the coordination of price and fiscal allocation, and taxation in particular. If the prices of certain commodities are adjusted downward in order to promote consumption, this will cause enterprise profits to be low and will inhibit the motivation of the producer... Under these conditions, we can decrease [...] the rate of taxation and adjust the rate of profit of enterprise, and achieve the objectives of guiding both consumption and production” (ibid., p. 8). Additionally, state control over the major economic proportions would be further bolstered through credit and a procurement policy (Xue 1982).

In September 1982 General Secretary Hu Yaobang delivered a report to the twelfth Party congress. Although Hu was a devoted proponent of reform, the report adhered to the moderate program proposed by Chen Yun. The direct impetus for the structural reforms introduced in the document was given by the aim to quadruple (*fan liang fan*) China’s industrial and agricultural output by the year 2000. The realization of this objective depended on a two-partite strategy, first to:

[A]im mainly at laying a solid foundation, accumulating strength and creating the necessary conditions; and in the second, usher in a new

period of vigorous economic development.<sup>101</sup> This is a major policy decision taken by the Central Committee.

HU 1982, P. 17

The initial stage of development in turn, consisted of two stages. Under the Sixth Five Year Plan, the strategy of readjustment, reform, consolidation and improvement would be maintained as the main policy line. During this period, the emphasis would be on reform of the administration of enterprise and central–local government relations, so as to secure sufficient state revenues for key projects—notably in energy, transport and infrastructure—and remedy the “blind expansion” of industry that had occurred as a consequence of market reforms.<sup>102</sup> Additionally—and in line with the recommendations of the State Planning Commission—the economy was to be regulated through a three-tiered system of mandatory (*zhilingxing*) and guidance planning (*zhidaoxing*), and market allocation (*shichang tiaojie*). Those producer goods and commodities allocated through mandatory planning would have fixed prices, and a relatively small number of consumption goods could be freely traded on the market. The majority of goods would be subject to guidance planning, and exchanged on the basis of negotiated or floating prices. In the subsequent Five Year Plan period (1986–1990) the emphasis would be on the improvement of the efficiency of production through a comprehensive project of “technological transformation” (*jishu gaizao*). The modernization of extant production capacity would eliminate the wasteful and inefficient pattern of production associated with the initial reforms and provide the conditions for a subsequent period of rapid economic expansion.

The proposal failed to resonate with more ardent proponents of reform. In his response to the report, the director of the Economic Research Institute of the Chinese Academy of Social Sciences, Liu Guoguang, argued that the regulation of production and exchange by centralized and mandatory plan would fail to incentivize enterprise, would promote wasteful production and

101 In fact, Hu's proposal was based on the “three-step” development strategy (*san bu zou*), first articulated by Deng in 1979. According to this framework, the two aforementioned stages would be followed by a third period, lasting until the middle of the 21st century, in which China would attain the status of a middle-income country.

102 In a surprising turn in discourse, Hu attributed the problems that had appeared under reform to “leftist” influences: “[T]he main causes for [the appalling waste in production, construction and circulation] are the ‘Left’ mistakes of the past, which resulted in blind proliferation of enterprises, an irrational economic structure, defective systems of economic administration and distribution, chaotic operation and management, and backward production techniques” (Hu 1982, p. 16).

would erode the emphasis on product quality and diversity. Liu Guoguang charged that “the consequences of reduced microeconomic returns had gradually outweighed [centralized planning’s] superiority in producing macroeconomic returns” (1982). Accordingly, the scope of planning ought to be further reduced in favor of additional market reforms. State leadership was, however, quick to repudiate Liu’s criticisms. An official response in the *People’s Daily* judged Liu’s assertion that planning would induce poor microeconomic results to be unfounded. It, moreover, added that divergence from the leading role of the law of planned proportionate development would cause the economy to become governed by the spontaneous force of the market, and be harmful to both the interests of the people and the socialist cause (Anonymous 1982).<sup>103</sup> In December 1982, the revised Constitution of the People’s Republic of China (PRC) proclaimed “socialist public ownership of the means of production” the basis of its socialist system, the state economy “the leading force in the national economy” and “coordinated growth of the national economy through overall planning” the guiding principle.<sup>104</sup>

The Sixth Five Year Plan, promulgated in December 1982 amounted to a partial endorsement of Hu’s proposals. The Plan stressed the need for increased fiscal centralization, stipulating that all investment in fixed capital—including that financed through extrabudgetary revenues—would be subject to approval by the State Planning Commission or its local branches, and all capital construction funds would be administered by the Construction Bank of China.<sup>105</sup> It likewise dictated that from here on out, the expansion of industrial output was to be chiefly realized through “technological transformation” (*jishu gaizao*, i.e. modernization of extant production technology).<sup>106</sup> While the plan thus ascribed a greater role to the central state, it omitted the emphasis on further sectoral readjustment. Instead, the plan rather unequivocally proposed the reinstatement of the strategy of accelerated accumulation. The projected rate of accumulation was adjusted upward to reach 29 percent by 1985. Although, in his address, Hu commented on the necessity of “taking agriculture at the basis,” he likewise insisted that:

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103 Given this strong condemnation of Liu’s article, one could wonder why it was allowed to be published in the first place. A plausible explanation is that Liu’s criticisms reflected the opinions of Hu Yaobang, who, however, had to refrain from proposing a more radical course of reform because of the need to maintain political coherence.

104 Constitution of the P.R.C., December 4, 1982, articles 6, 7, 15.

105 “Guomin jingji he shehui fazhan di liu ge wu nian jihua (tiyao)” (1982).

106 *Ibid.*, ch. 1.

[L]iving standards can increase only by increasing production, and not by cutting into funds indispensable to national construction[.] Specifically, we can no longer increase peasant incomes through raising the prices of farm produce or through lowering the fixed quotas of state purchases and enlarging the scope of negotiated prices.

1982, P. 17

Notably, support for a more balanced trajectory of growth was not reiterated in the final iteration of the Five Year Plan, and, both within policy and academia, the emphasis on accelerated accumulation under intensified central control prevailed. As a consequence of the renewed emphasis on accelerated industrialization the more balanced strategy of economic development that had emerged in the late 1970s and early 1980s was once again overturned.

Although Hu's address to the twelfth Party congress had stressed the need to pair central control with the reorganization of enterprise administration, reforms within public industry unfolded at a slow pace. Arguably to prevent overaccumulation or duplication of investments in non-priority sectors, further enterprise reforms were omitted from the Sixth Year Plan. The financial and operational authority given to enterprise under the "eight rights" policy of 1980 had been partially revoked in favor of an elaborate, multitiered administrative system that stipulated production targets, tasks and corresponding remuneration. In 1983, the project of enterprise reform revolved around the trial implementation of a new corporate taxation system. Under the new tax regulations, enterprise transfers to central government would be comprised of a fixed proportion of profits, as well as a negotiated remittance.<sup>107</sup> The policy was intended both to increase the financial prowess of the center as well as to offset any arbitrary interfirm differences in profitability owing to external factors, and irrational prices in particular (Zhang 1984). The limited progress under the Sixth Five Year Plan was decried by advocates of reform, who considered the measures taken by the state to be insufficient to incentivize enterprise (Xue 1994).

In 1982, the Office for Reform of the National Economic System (*guojia jingji tizhi gaige bangongshi*) was elevated to the position of commission directly under the State Council. In early 1984, the commission started work on the "Decision on Reform of the Economic System." The policy, officially adopted during the third plenary session of the twelfth Party congress in October 1984, called for a reform of every aspect of the entire economic structure. This involved a whole range of reforms, including planning, pricing, economic

107 "Guanyu guoying qiyeli gaishui shixing banfa" (1983).

management, and the labor and wage system. The majority of these reforms were to be accomplished within five years. The goal was to make the individual enterprise an independent economic entity responsible for its own profits and losses, and able to act as a legal person with certain rights and duties.

The Decision claimed that in the reform of the planning system “it is necessary, first of all, to discard the traditional idea of pitting the planned economy against the commodity economy.”<sup>108</sup> In fact, according to the Decision, a socialist economy is a “planned commodity economy,” and the difference between socialist and capitalist economy does not lie in whether commodity economy and the law of value are still functioning, but in the difference in ownership. In short, it is public ownership of the major means of production which defines a socialist system, not the structure of the planning system. The implication was that it is possible to attempt far-reaching reforms of the planning system without altering the fact that China is a socialist country.

The Decision likewise emphasized the need to address the problem of irrational planned prices. This included inadequate price differentials for a given product with varying quality, irrational price ratios between different commodities, particularly low prices for some mineral products and raw and semi-finished materials; and the retail price of major farm and sideline products being lower than their state purchasing price. The Decision admitted that this situation constituted an obstacle to the reform of the planning system: “Therefore, reform of the price system is the key to the reform of the entire economic structure” (Guanyu tizhi gaige de jue ding 1984). The Decision recommended a three-tiered pricing system to reflect and also support the tripartite management system: planned prices for essential products covered by the state plan, floating or negotiated prices for products under guidance planning, and free prices for products circulated in the free market.

Suggestions to pay more attention to what the Chinese call economic levers (pricing, taxation, credit etc.) were combined with suggestions to implement a wage and labor reform “in accordance with the principle of linking wages with responsibilities and achievements” so as to reflect more fully “the differences between mental and manual, complex and simple, skilled and unskilled, and heavy and light work” (ibid.). Along these lines there was also a call for an enterprise management system where the director or manager assumes

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108 “Guanyu jingji tizhi gaige de jue ding” (1984). This phrase was the subject of a large number of articles in the fall and winter of 1984. See, for example, *Guangming Ribao* on December 9 and December 10, 1984, and *Jingji Ribao* on November 19 and 21, 1984. See also the article by Liu Guoguang who by now had become vice-president of the Chinese Academy of Social Sciences (Liu 1984).



full responsibility. The Decision pointed out that a thorough reform of the economic structure required a contingent of managerial and administrative personnel, and especially managers knowledgeable in modern economics and technology. It was therefore considered necessary to promote a new generation of managerial personnel. This was called “reshuffling of leadership in enterprises,” and was to be completed before the end of 1985. The “Decision on Reform of the Economic Structure” was given wide coverage in the media in China as well as abroad. The Chinese used phrases like “great practical importance” and “far-reaching historical significance” in order to emphasize that this time the reform process did not aim at partial and minor alterations of the system, but rather had entered a stage of “comprehensive reform.”

Following the promulgation of the Decision, the number of industrial products regulated by the mandatory plan was reduced from 120 to 60; centrally controlled agricultural production was limited to 10 commodities (previously 29); and the variety of centrally distributed materials was scaled back from 256 to 65 (Song 1985).<sup>109</sup> Further adjustments to the price system were made the following year. In March 1985 the Central Committee issued a circular (*zhongfa*) which consolidated the shift from planning to market regulation in farm production. State purchasing quotas were to be abolished, and instead the state would buy grain and cotton according to contracts and allow farmers to sell their surplus production in the open market. Other agricultural goods were allowed to float at free market prices (Brødsgaard 1991). In May 1985, the state introduced the dual-track system (*shuangguizhi*). Enterprises producing goods under the mandatory section of the economic plan would enjoy state-stipulated reduced prices for key inputs such as coal and steel. Other enterprises would purchase materials on the market.<sup>110</sup> As in the late 1970s, the reforms invigorated the economy, resulting in rapid growth throughout 1985. However, as before, the upturn in industrial production brought on the all-too-familiar problems of overaccumulation and reduced central fiscal control.

Moreover, devolution of financial control and rising wages resulted in an upsurge of demand for investment and consumer goods, causing inflation to reach 9.3 percent. In the era of economic planning, the state had retained control over funds and production quota, and consequently, prices had only fluctuated by a narrow margin. This is not to say that under the Maoist system demand had not at times gravely surpassed supply. On the contrary, the persistent prioritization of industrial expansion had resulted in a chronic shortage of consumer products (see Zwass and Westphal 1978). However, with the

109 Also, *Beijing Xinhua* (1984, pp. 31–32).

110 “Guanyu jin yi bu kuangda guoying gongye qiye zizhuquan de zanxing guiding” (1984).

introduction and rapid expansion of the market economy, such imbalances translated for the first time into periods of high inflation. Although absent in the planned economy, inflation did not altogether fall outside the scope of socialist economic analysis. Marx had dealt with the causes of inflation in his first volume of *Capital*.

According to Marx, changes in general price levels—expressed through the medium of money—are caused either by a change in the general value of commodities, or a change in the value of the money commodity. Marx provided various reasons why the value of the money commodity (as opposed to its denominational value, i.e. the amount of money units assigned to notes and coins) can change, but only one is relevant to the explanation of inflation in modern capitalist systems. When the volume of money in circulation is increased absent a commensurate increase in aggregate demand (i.e. the societal need for labor and capital), the exchange ratio between the money commodity and goods is altered, so that goods now trade for a greater increment of money, that is, a higher price (Marx 1990, ch. 3). While Marx considered inflation to be an intrinsic and unavoidable element of capitalism, his diagnosis acquiesced with central elements of monetary explanations. Accordingly, when increasing international academic exchange exposed Chinese economists to monetary and Keynesian theories,<sup>111</sup> these ideas rapidly permeated into the Chinese economic discourse. Economists such as Liu Guangdi of the Central Research Institute for Public Finance insisted that control of the money supply was crucial to regulating production and ensuring price stability. Through the joint use of monetary and fiscal instruments such as interest rate and credit control, taxation and subsidies, the state would be able to either stimulate production or reduce inflationary pressure. Excessive increases of the money supply (utilized, for example, as a means of reducing unemployment or balancing national trade accounts), causing large deviations from aggregate demand were to be avoided (Liu 1985b).

Liu Guoguang reiterated the unsuitability of Keynesian policy, arguing that “considering the generally excited state of socialist economies, increases in the monetary supply can only exacerbate the level of economic anxiety” (Liu 1985a, p. 14). From the latter half of the 1980s onward, monetary policy became a staple of economic governance. In January 1985, the State Council had begun

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111 For example, following central concerns about economic instability, the Chinese Academy of Social Sciences and the Research Unit for Economic System Reform jointly hosted a conference on macroeconomic management in September 1985. The conference was attended by economists both from Eastern European transition and capitalist economies.

to convert funds earmarked for the expansion of enterprises' fixed assets into interest-bearing loans. The central state increasingly relied on the manipulation of interest rates to discipline SOEs and reduce inflationary pressures. However, Liu Guoguang forewarned that under conditions of pervasive soft budget constraints—wherein the state continued to bear ultimate responsibility for firm expenditures—managers would prove insensitive to the effect of changes in the interest rate on the financial performance of enterprise (*ibid.*). Indeed, the efficacy of monetary and fiscal policy under Zhao Ziyang and Hu Yaobang continued to be marred by the obstacles of incomplete reforms.

### **Price and Ownership Reform, Inflation and the Origins of the Tiananmen Incident**

However, in spite of the reemergence of macroeconomic imbalances in 1985, Hu Yaobang and Zhao Ziyang were determined to sustain the momentum of reform. The decision to accelerate reform caused disagreement among senior leadership, bringing an end to the alliance of Chen Yun and Deng Xiaoping that had ushered in the first phase of reforms. Discussing the initial draft of the Seventh Five Year Plan at the national convention of the CCP on September 23, 1985, Chen Yun proved strongly critical of initial proposals (Naughton 2009). According to Chen Yun, agricultural reforms had induced farmers to focus on the production of cash crops and neglect grain cultivation, while decentralization within industry had brought about runaway growth and overaccumulation. Moreover, the receding influence of the central state and expansion of the market had provided the incentives and opportunities for corruption, causing popular dissatisfaction. The resolution of these problems, argued Chen, depended on maintaining the maxim of upholding the planned economy as the main element and the market economy as a complement, and renewing the emphasis on ideological education (Chen 1986). However, in an address given that same day, Deng expressed his unwavering support for the reforms, stating that the achievements within the subsequent Five Year Plan period would prove crucial to the success of the overall strategy of quadrupling China's economic output by the year 2000. Moreover, Deng added that it was inevitable that these comprehensive changes would be paired with a certain amount of disparity between individuals and regions, but that ultimately the economic invigoration resulting from reforms would benefit all (Deng 1985).

Despite the objections of more conservative leadership, the prevailing sentiment during the years leading up to and following the promulgation of the new Plan was that the scope and pace of reforms ought to be increased. How-

ever, policymakers and academics were not insensitive to the contradictions that had appeared in the preceding years. Gradually, the debate on economic reform shifted away from the initial doctrinaire perspectives, wherein the law of planned proportionate development, macroeconomic balance and centralized control were juxtaposed against the law of value, microeconomic performance and decentralization. Instead, a consensus that the objective of reforms was to bring about and maintain simultaneous microeconomic equilibrium and macroeconomic stability formed. Due to the easing of ideological constraints and greater foreign academic exchange, academics could now draw on Western economic theories too. Jointly, the influx of novel ideas and methods and the ostensible incapability of the extant paradigm to provide an adequate response to the problems accompanying China's economic development caused discourse to gradually depart from the narrow socialist analysis of sectoral proportions. One major consequence of this development was the emergence of the concept of rationality in economic discourse.<sup>112</sup> According to China's leading economists, the imbalances that had periodically appeared were due to the partial and erratic manner in which reforms had been carried out. As a result, irrationalities had cropped up both within the management of enterprise and economic governance.

A first problem was caused by enterprises' concurrent pursuit of the maximization of output and employment, prompting the reckless expansion of productive capacity. Such behavior was encouraged by the state's patronage of poorly performing enterprise. Because the allocation of credit was still largely determined on basis of production quota, the correlation between investment and profitability was obscured, causing management to ignore the rate of return on capital (Hu and Lu 1986; Liu 1987). Rather, enterprise managers used bank credit to expand production and employment or increase wages.<sup>113</sup> Additionally, Party secretaries had retained *de facto* ultimate authority over the management of enterprise, and regularly interjected objectives that detracted from management's pursuit of profits.

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112 Different definitions of rationality were put forward. One conception considered rational behavior to entail rapid adjustment to prevailing conditions of plan or market, and the steady expansion of productive accumulation; a second view reiterated the classical position that the rational enterprise, by engaging in the pursuit of profit, would promote the maximization of public utility; a third emphasized the removal of internal and external inefficiencies to be the essence of rational economic behavior; see Liu (1987).

113 Although not explicitly referenced, this argument clearly draws on the theory of principal-agent problems put forward by Berle and Means (1965).

Solutions to the problems of irrational enterprise behavior differed. The separation of ownership and management rights was widely proscribed. Because, under soft budget constraints, economic efficiency was inconsequential to the operation of enterprise, management habitually engaged in loss-inducing practices (Zhou, Liu and Zhang 1986). Moreover, enterprises had been shielded from competition by protectionist policies issued by industrial ministries and local government. Xue Muqiao argued that through the introduction of the managerial responsibility system (*jingli zerenzhi*), the influence of Party organs within enterprise would be scaled back, and management would be held solely accountable for firm performance. The state, as owner of the enterprise, would retain the right to appoint and dismiss management (Xue 1987). The separation of state and enterprise (*zhengqi fenkai*) was considered crucial in bringing an end to the soft budget constraint within public industry. Others went further still, arguing for changes to the ownership system itself. By implementing joint stock ownership, enterprise assets would be shared between the state and management and employees, ensuring both parties' interest in the financial performance of the firm (Li 1986).

Problems at the level of enterprise were compounded by irrationalities in pricing and fiscal policy. The arbitrary application of "adjustment taxes" following the debate on irrational disparities in enterprise profitability had resulted in a situation where enterprises with above-average financial performance ended up remitting a disproportionate proportion of revenues to the state (Yue and Yue 1987). A group of economists maintained that because of this phenomenon of "whipping the fast ox," firms were disincentivized to increase productivity (Zhou, Liu and Zhang 1986). Others emphasized price reforms. Thus, Zhou Shulian (1986) held that, regardless of the transfer of financial and operational authority to enterprise, the relationship between productivity and performance would continue to be distorted absent the comprehensive liberalization of factor prices (including raw materials, technology and labor). Within the first phase of reform, the central state had relied chiefly on price controls to ensure that sectoral development and supply and demand accorded with macroeconomic objectives. The development of a dual-track pricing system, in which planned and market prices widely diverged, provided SOEs ample opportunities for engaging in arbitrage by selling material procured at reduced prices on the free market. Accordingly, Dai Yuanchen of the Chinese Academy of Social Sciences advocated the abolishment of the two-track pricing system (Dai 1986). This did not imply that the state should completely relinquish its control over prices; government intervention in pricing was still deemed necessary in order to alleviate inflationary pressures and remedy instances of insufficient market supply. However, both the scope of state-

controlled prices, and their divergence from market prices, was to be gradually reduced (Li 1987).

While the diagnosis of the general obstacles to rationalization of the economic system was widely shared, a division developed between those arguing for an emphasis on completing the transfer of fiscal and operational responsibility to enterprise, and those prioritizing adjustment of the price system (Hsu 1989; Naughton 2009). The former believed that without first completing the separation between state and enterprise, further price liberalization would prompt price appreciation and cause overinvestment. The latter argued that enterprises could not be induced to function competitively without first removing regulatory rents and opportunities for arbitrage.

The outline of the Seventh Five Year Plan, published on September 4, 1986, reflected the accelerated momentum of reforms. The plan's relatively modest economic targets<sup>114</sup> reiterated the notion that reforms would require restructuring at the level of enterprise,<sup>115</sup> which would temporarily reduce the growth rate of output. Nevertheless, so as to minimize the disruptive influence of reform and prevent economic stagnation, credit and infrastructural funds were increased by a large margin.<sup>116</sup> In order to resolve bottlenecks in upstream sectors, a greater proportion of investment would be allotted to the development of raw materials' extraction and processing, transport, energy and telecommunications. Expenditure for the technological transformation of enterprise would also be increased by a margin of 80 percent, compared to the previous Five Year Plan period.

Under this basic framework, the strategy for reform under the Seventh Five Year Plan would unfold in two stages. Within the first two years, the financial and operational independence of enterprise would be established.<sup>117</sup> All enterprises would be subject to the managerial responsibility system. Moreover, a large number of small or medium-sized SOEs would be transformed into collective or private enterprises. In the latter three years, policy would focus on market reforms, by promoting the further substitution of indirect for direct controls. After the completion of the devolvement of fiscal responsibility, the state would also be able to continue with the adjustment of the taxation

114 The plan proposed an average annual growth rate of GDP of 7.5 percent, compared to the 10.8 percent realized during the Sixth Five Year Plan.

115 First put forward in the two-stage strategy of quadrupling China's GDP by 2000.

116 Funds for investment in fixed capital under the Seventh Five Year Plan would total RMB 81.96 billion, compared to outlays of 36 billion in the Sixth Five Year Plan.

117 "Guomin jingji shehui fazhan diqi ge wu nian jihua (zhaiyao)" (1986).

system so as to eliminate arbitrary discrepancies in the financial conditions of enterprise.

Following the promulgation of the plan, the State Council went ahead with a full-scale implementation of the managerial responsibility system.<sup>118</sup> The system would provide management with the authority to engage in the drafting of the enterprise's operational plans, and the Party committee would be relegated to a supervisory status. Additionally, the center sought to dilute the corporate control of industrial ministries and provincial government through the development of horizontal linkages (*hengxiang lianhe*) between enterprises. By creating large diversified enterprise groups that operated at a national scale, industrial or provincial bureaus would no longer be able to unilaterally dictate their operational remit.<sup>119</sup> Subsequently, policies were introduced to separate state and enterprise finance. The "Enterprise Bankruptcy Law", introduced on a trial basis in December 1986 further advanced the objective of financially independent enterprise. The following year, the scope of the contract responsibility system (*chengbao jingying zerenzhi*)—which the state had begun to experiment with from 1983—was expanded, further increasing managerial autonomy.<sup>120</sup> The state's influence over enterprise finance was nominally limited to the taxation of profits and contractual stipulation of targets for technological transformation. By linking enterprise wage expenditure directly to profits, the state sought to put an end to the indiscriminate expansion of wages and employment (Yue and Yue 1987).

Despite their fairly comprehensive scope, policies introduced in 1986 and 1987 failed to truly instill greater economic discipline within enterprise. Although the measures nominally acquitted the state from the financial responsibility for enterprise, the soft budget constraint remained intact. No progress was made with the collectivization or privatization of enterprise. Although the relaxation of ideological constraints had allowed for the transformation of the relations of production, public ownership of the means of production—enshrined in the 1982 Constitution—was considered the *sine qua non* of socialism. For the same reason, the Bankruptcy Law failed to have any significant influence, and the number of SOEs continued to grow (NBS 2005, table 41). Incomplete regulation further contributed to the continuation of non-productive practices. Although, under the contract responsibility system,

118 "Guowuyuan jue ding jin yi bu shixing changzhang fuzezhi fenfa san ge tiaolie de tongzhi" (1986).

119 "Guanyu jin yi bu tuidong hengxiang jingji lianhe ruogan wenti de guiding" (1986).

120 The contract responsibility system was subsequently enshrined in the Enterprise Law of 1988.

enterprise loans were no longer explicitly guaranteed by the state, enterprises were not legally obliged to repay their debts to banks. Moreover, the state continued to be financially accountable for interest payments, because these were included in expenses and subtracted from profit remittances to central government (Bowles and White 1989). Because banks lacked the capacity to closely monitor enterprise performance and were under pressure to allocate credit in accordance with central plans, indiscriminate lending to poorly performing enterprises continued.

Popular unrest, incited by demands for political reform and rapidly increasing inflation weakened the support for reforms amongst central leaders. A series of consequential personnel changes occurred within the Party and state throughout 1987. Senior leaders Deng Xiaoping and Chen Yun retired from the CCP's Politburo Standing Committee (*zhengzhiju changwei*), China's de facto most powerful policy body.<sup>121</sup> Among the four new members introduced, Hu Qili was the most ardent proponent of reform. Yao Yilin (head of the State Planning Commission) and Li Peng (who took on the position of premier vacated by Zhao) both supported the conservative Chen Yun, while Qiao Shi took a more ambiguous position. Earlier, in January of that year, Hu Yaobang had been relieved from his position as Party general secretary—allegedly over disagreements with Deng concerning succession and the course of political reforms (Dietrich 1998). Nevertheless, under the patronage of Deng, Zhao Ziyang—who had taken over Hu's post of general secretary—was still able to direct the course of economic policymaking, in spite of criticism from Chen Yun and the conservatives.

Thus, despite the questionable efficacy of enterprise reorganization and objections from conservative leaders, the state persisted with the measures set out in the Seventh Five Year Plan. At the thirteenth National congress, in October 1987, the theory of the “primary stage of socialism” was formally endorsed by the CCP, providing the ideological justification for further departure from the model of the plan economy. In February of the following year, the State Commission for Economic Restructuring (*guojia jingji tizhi gaige weiyuanhui*) published an extensive outline for further enterprise and market reforms. The plans were followed by the announcement of further price liberalization by Zhao and Deng in August of 1988.<sup>122</sup> With inflation already growing at an alarming rate, public expectations of further price increases caused panic buying and led to severe shortages.

121 Deng, however, retained his title as chair of the Central Military Position and remained de facto paramount leader.

122 “Guanyu jiage, gongzi gaige chubu fangan” (1988).



The economic turmoil stopped reform dead in its tracks. Although Zhao maintained his position as general secretary, control of economic policy was promptly transferred to Li Peng and Yao Yilin. In response to the mounting economic problems, Li and Yao followed the conservative mantra of recentralization and retrenchment.<sup>123</sup> While nominally insisting on the importance of reform, the new economic leadership quickly proceeded to reinstate price controls, reduce the money supply and halt fixed asset investment outside of the plan.<sup>124</sup> The measures, however, proved ineffective in restraining inflation and unsustainable as they caused supply to decrease at a faster rate than demand.<sup>125</sup> Moreover, the restricted flow of credit to enterprise affected wages. The growing discontent of urban workers coalesced with students' and intellectuals' increasing demands for political reforms, setting the stage for the Tiananmen protests, which would culminate in the tragic events of June 4.<sup>126</sup>

### Tiananmen and the Reemergence of Conservatism

The economic and political consequences of the Tiananmen incident were profound. Whereas the general trend prior to the incident had been toward the retrenchment of government, central control now became the overriding imperative. Zhao Ziyang, who had proved sympathetic to the demands of the student protesters and intellectuals, had been ousted two weeks before the Tiananmen military crackdown on June 4, 1989. The position of Party secretary was given to Jiang Zemin, who had previously served as Party leader in Shanghai. The appointment of Jiang—who was politically conservative but

123 Reflecting on political developments in the 1988, Zhao stated: “When ‘adjustment and reorganization’ began, [Li Peng and Yao Yilin] believed that my position in economic affairs had weakened. They took controlling power, which meant the Politburo Standing Committee, the Central Economic and Financial Leading Group, and I could no longer run economic affairs. Thus they were able to restore many of the old methods, in the name of ‘adjustment and reorganization’” (Zhao 2009, pp. 233–234).

124 “Guanyu zuo hao dangqian wujia gongzuo he wending shichang de jinji tongzhi” (1988). “Guanyu qingli guding zichan touzi zai jian xiangmu, yasuo touzi guimo tiaozheng touzi jiegou de tongzhi” (1988).

125 Due to the persisting soft budget constraint, enterprises tended to lower output when credit contracted, withholding retained profits to reinvest in the expansion of production and wages at a later point, see Naughton (1996, pp. 266–268).

126 For an account of the pro-democracy protests and military crackdown, see Beja (2010), on intra-Party debates surrounding the handling of the Tiananmen incident, see Nathan (2001) and Zhao (2009).

had proven sympathetic to reform—was ostensibly a compromise between Deng Xiaoping and Chen Yun.

However, coming from relative political obscurity, Jiang's political influence was limited. With the removal of Zhao and most of the reformists, Li Peng was now in unambiguous control of economic policy. Initiatives to transfer financial authority to enterprise were halted altogether. The rapid proliferation of state-owned and collective industry under decentralization had precipitated excessive demand for investment, caused shortages in agriculture and upstream sectors, and severely weakened the center's fiscal control. In the following years, leadership reverted to the traditional credo of consolidation and adjustment. The former authority of the Party committees within enterprise was reinstated.<sup>127</sup> In tandem, central leadership sought to extend its control over credit allocation, basic construction funds and pricing. The scale of capital investment was to be scaled back by a large margin, and a larger proportion would be allocated to heavy industry and agriculture. The dual-track pricing system was to be retracted to return to a system of more elaborate direct price management (Perkins 1990).<sup>128</sup>

Significant reductions in the supply of credit and funds for capital construction in 1989 and 1990 slowed down the expansion of industry, while limited wage increases constrained consumption. The fiscal measures were accompanied by high interest rates (promoting a rapid increase of deposits) and a contraction of newly issued currency. Jointly, these measures were successful in slowing down accumulation and curbing inflation. Between 1989 and 1990, total investment in fixed assets went from 25.4 percent growth to actually decreasing by some 7.8 percent. Simultaneously, the consumer price index dropped from 118.0 to 103.1 (NBS 1999, table 9-1).

Nevertheless, the conservative leadership, considering inflation but a symptom of more fundamental structural imbalances, sought to further increase its control over economic activity. The Eighth Five Year Plan introduced further measures to centralize the allocation of credit and investment funds, so as to promote the development of upstream sectors (and energy in particular), which were believed to have been neglected as a result of market reforms. Investment in agriculture too was to be increased, but responsibility was delegated to local government and TVEs.<sup>129</sup> The renewed emphasis on heavy industry was in part motivated by a desire to boost profits appropriable from

127 "Guanyu jin yi bu gao hao qingli zhengdun gongsi gongzuo de si tiao cuoshi" (1989).

128 "Guanyu jin yi bu zhili zhengdun he shenhua gaige de jue ding" (1989).

129 "Zhonghua renmin gongheguo guomin jingji he shehui fazhan shi nian guihua he di ba ge wu nian jihua gangyao" (1991).

centrally controlled enterprises, and counter the progressive decline of central revenues. However, the policies introduced by Li had severely constrained the profitability of SOEs operating within heavy industry. Price controls on industrial inputs and reduced downstream demand had squeezed revenues, while the costs of fixed capital had increased (Naughton 1996, ch. 8). Nor had the detrimental consequences of contractionary measures been limited to upstream industry. In 1989, overall economic growth had plummeted to 3.8 percent, and, at 4.1 percent in 1990, prospects for economic revival seemed bleak. Indeed, voices calling for the continuation of reforms started to increase in 1991, and in January 1992, Deng Xiaoping made a series of appearances in several southern provinces that, though informal, proved highly instrumental in rekindling the enthusiasm for decentralization and marketization. To Deng, the Tiananmen incident was not about economic reform, but about political power and control. He was convinced that once political control had been restored, the economic reform process had to be resumed. During his “southern inspection tour” (*nan xun*), Deng emphasized that those in central leadership who were opposed to reform must step down (Vogel 2011, pp. 669–690). Jiang Zemin and the new leadership realized they could not ignore this threat by Deng, who still held tremendous sway within the Party, and they accordingly abandoned their austerity policies in favor of renewed reform.

However, in the subsequent period, reforms would be of a fundamentally different character. Periodic reversions to the principles of centralized allocation and the limitation of managerial autonomy had led the leadership to believe that comprehensive planning would induce poor microeconomic results and slow down growth. However, the inflation that had accompanied unbridled decentralization had likewise espoused a conviction—strengthened by the social instability of the late 1980s—that strong central macroeconomic control would be indispensable.

### Economic Developments in the First Phase of Reform

The initial impetus to reform was provided by severe intersectoral imbalances that had resulted in the stagnation of the overall economy and agriculture in particular. In the period of the Cultural Revolution (1966–1976), economic growth had decreased to an average 5.9 percent, while growth in agriculture had plummeted to 2.8 percent. In the first period of reforms (1978–1992), the rate of overall economic growth had climbed to an impressive average 9.6 percent; agriculture too had achieved steady growth at 5.2 percent (NBS 2005, table 8). Initial reforms focused on sectoral readjustment by putting an end to the strategy of agricultural expropriation. The development of a

TABLE 5 *Average annual growth rates of agriculture, 1952–1984*

Subsector	1952–1978	1978–1984
Crops	2.5	5.9
<i>Grain</i>	2.4	4.8
<i>Cotton</i>	2.0	17.7
Animal husbandry	4.0	10.0
Fishery	19.9	12.7
Forestry	9.4	14.9
Agriculture (total)	2.9	7.7

SOURCE: LIN (1992, P. 35).

supplementary market for produce prompted farmers to shift production toward cash crops and livestock, which fetched higher prices.

The rural economy was further invigorated by the rapid proliferation of TVEs. Fueled by idle rural labor, local state investment and strong demand for consumer goods, employment in TVEs increased from 28.3 to 92.6 million, and output surged from 49.3 to 958.1 billion RMB between 1978 and 1990.<sup>130</sup> Public industry likewise continued to grow at a rapid rate. SOEs in heavy industry had remained the focal point of economic planning and continued to receive the lion's share of centrally allocated funds and credit. Moreover, increased production of consumption goods had led to an increase in demand for machinery and raw materials (Pei 2005). Although the development of industry was temporarily decelerated by the suspension of planned investments in 1981, policy continued to reflect a perspective that equated economic growth with industrial development, and overall, the growth of industry continued to outpace that of agriculture. The expansion of industry in turn drove the rapid development of trade and retail services, particularly after 1984, when the scope of planned material allocation was significantly reduced in favor of market exchange. Although national policy had emphasized the development of industrial infrastructure, the telecommunication and transportation sectors grew but moderately.<sup>131</sup> All in all, the objective of sectoral readjustment, first formulated in the late 1950s, was not realized, and economic growth continued to be driven primarily by accumulation within industry (see Figure 5).

<sup>130</sup> For comparison, agricultural output in 1990 totaled 766.2 billion.

<sup>131</sup> The energy sector, on the other hand, developed rapidly during the first phase of reforms.

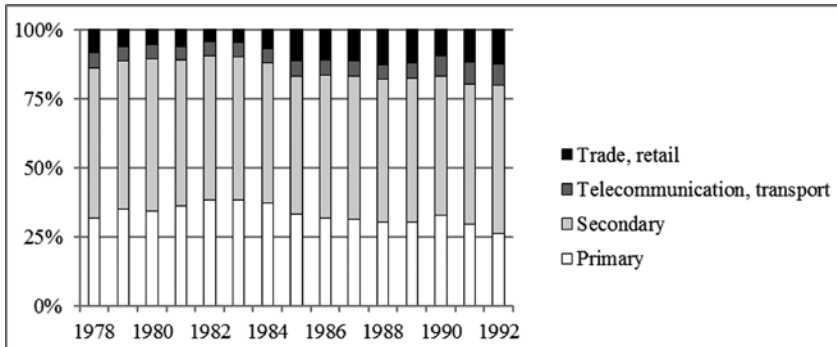


FIGURE 5 Sectoral composition of GDP, 1978–1992.

The failure of the readjustment strategy can be ascribed to its inherent incompatibility with reforms. Within the Maoist system of economic planning, sectoral adjustments had been achieved by way of changes in central allocation. However, the transfer of financial authority from the state to enterprise—central to attempts to improve productivity—had led to a weakening of the state. Between 1978 and 1992, state revenue decreased from 31.2 to 13.1 percent of GDP. Accordingly, the central state's capacity to directly influence the sectoral composition of the economy was severely curtailed.

Nevertheless, the comparatively limited growth of agriculture did not bring about the severe shortages that periodically emerged in the Maoist era. Although conservatives had continued to criticize the neglect of agriculture and staple crops in particular, efficiency in grain production had increased.<sup>132</sup> Moreover, China's progressive integration into the world economy allowed it to compensate for shortfalls in the domestic harvest through international trade (Perkins 1990). At the same time, the transfer of agricultural labor to light industry through the establishment of TVEs had invigorated the rural economy and caused the gap between rural and urban incomes to narrow.<sup>133</sup> While subsequent plans would continue to emphasize the development of the agricultural economy, concerns over the livelihood of the rural population would take precedence over issues of food security.

Although reforms had successfully dealt with the stagnating production and acute shortages within agriculture, it also gave rise to novel economic

132 In 1992, per capita output of grain was 19.3 percent higher than that of 1978, the largest harvest recorded prior to agricultural reforms.

133 Note that, following the austerity measures of 1986, and again in 1989, the divergence between urban and rural incomes widened again (Huang 2008).

problems. The devolution of control over fiscal allocation to enterprise and local government promoted rapid economic growth, but also resulted in an upsurge of demand for credit, which could only be accommodated through an increase in the supply of currency. Most inflationary pressure was attributable to SOE. Not only were SOEs the main recipients of bank credit, but soft budget constraints caused enterprise management to be inattentive to productivity. Loans made to SOEs were habitually used to finance wage increases, which exacerbated inflationary pressures. Because of the excessive demand for investment and consumer goods, periods of decentralization were consistently characterized by the concurrence of rapid growth and inflation. While monetary measures were utilized in attempts to indirectly manage demand, such interventions had but a limited effect. Although high interest rates tempered panic buying and reduced currency in circulation, industrial demand for credit remained high. The state periodically reverted to the centralization of control over credit, but ideological and political constraints limited the scope of adjustments within public industry. Rather, contractions in credit supply predominantly affected TVES, which were the primary drivers of economic growth. As a result, economic growth in the first era of reforms was characterized by the alternation of periods of high growth and inflation during decentralization, and periods of economic stagnation under recentralization (see Figure 6).

Not only did public industry's incessant demand for capital contribute to periodical inflation, but it caused structural imbalances that increasingly undermined the viability of Chinese economic development. Measures to devolve financial and operational authority had not been able to ensure the efficient operation of SOEs. Because the state continued to rely on public

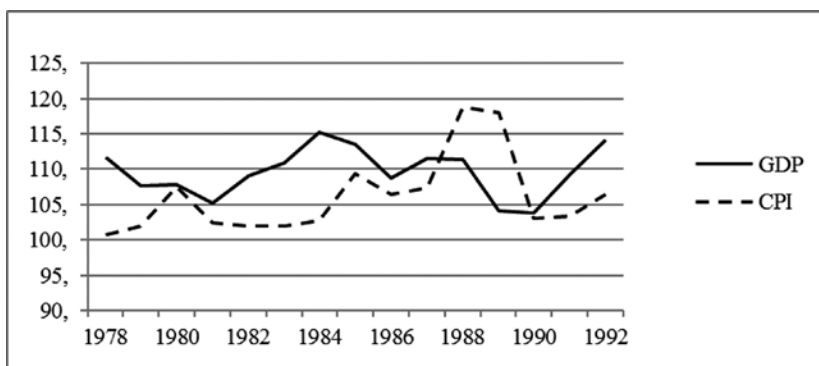


FIGURE 6 GDP growth and inflation, 1978–1992 (percentage change over previous year).  
SOURCE: NBS (2005, TABLES 6, 29).

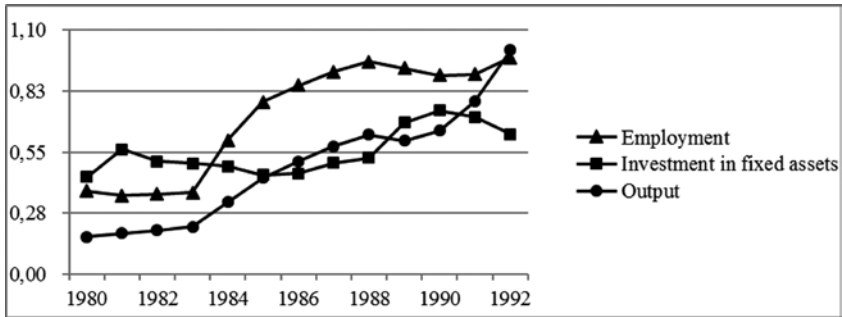


FIGURE 7 *Industrial output, employment and investment in fixed assets of TVES as ratio of SOEs, 1980–1992.*

SOURCE: NBS (1993, PP. 333–335).

enterprise to fulfill its plan targets and provide employment to urban workers, the soft budget constraint persisted, and public industry continued to lay claim to disproportionate shares of labor and capital. Although the inefficiency of SOE was partially offset by the rapid growth of TVES (see Figure 7), public industry had gradually become an unsustainable burden on the central state.

Problems of inefficiency were compounded by the removal of price controls in 1985, which eroded SOE profitability. From 1985 to 1992, direct subsidies to loss-making SOE accounted for an average 3.2 percent of GDP. The actual costs of these loss-making enterprises were much higher still due to indirect transfers in the form of unpaid credit and interest (Brandt and Zhu 2000). Simultaneously, the capacity of the central state to support unprofitable enterprise had become increasingly limited because of the marginalization of central state revenues. Not only had substitution of profit remittances for profit tax caused overall state revenue to drop considerably, but due to decentralization the national (as opposed to local) share of revenues had decreased even more rapidly.

All in all, the outcomes of economic development during the first stage of reform had been equivocal. On the one hand, reforms had resulted in a departure from the strategy of industrialization by way of agricultural expropriation in favor of a more balanced trajectory of development. The establishment of TVES promoted the development of light industry and increased rural living standards. The introduction of market relations increased the productivity of the primary sector and improved the supply and quality of consumer goods. On the other hand, economic growth had been volatile and persistently resulted in macroeconomic imbalances. Moreover, reforms had failed to invigorate public industry, and in certain respects had exacerbated unpro-

ductive behavior, as the expansion of managerial autonomy and the development of a market component along the plan economy had created ubiquitous opportunities for rent-seeking. The costs of such practices had fallen predominantly on an increasingly economically impotent central state.

### Conclusion

Reforms in the late 1970s had been initiated with the explicit objective of departing from the Maoist strategy of accelerated industrialization in favor of a more balanced trajectory of reform. However, by the end of the first phase of reforms, the autonomy given to enterprise and the regulatory function attributed to market allocation had expanded far beyond the parameters of the vision espoused by Chen Yun in the late 1950s. Both ideological and economic developments had contributed to these profound changes in the leadership's perception of the project of economic reform. The disruption caused by the anti-rightist polemics of the Great Leap and the Cultural Revolution had instilled in Deng and his fellow leaders a vehement antipathy toward ideological excess. The purge of the Gang of Four signaled a reversal in the status of the relations of production and the productive forces. Although under Deng, leadership occasionally reiterated the importance of ideological work, the emphasis was unequivocally on the development of China's economic prowess through the adoption of efficient production technology and methods, and the improvement of the mechanisms of allocation and economic governance. With the introduction of "practice as the sole criterion of truth" as the major guideline for economic debate, and the "primary stage of socialism" as the official diagnosis of the contemporary state of the economic system, the Party created leeway for ideas both foreign and domestic, which would have previously been decried as rightist and therefore unacceptable.

In spite of this more liberal intellectual climate, the traditional socialist analysis of sectoral relations initially continued to provide the main framework for discussing China's economic development. Until the mid-1980s, the prevailing understanding among state leadership was that the main purpose of reform was to ensure an appropriate relationship between accumulation and consumption, and regulate the composition of production. Within this context, market production and exchange were regarded as useful expedients to increase production within agriculture and light industry. However, soon after the initiation of reforms, it had become obvious that leadership had failed to align the objectives of sectoral adjustment and decentralized production. The devolution of financial authority prompted high investments in fixed capital,



a comparative neglect of agriculture and the accumulation of excess productive capacity. The incompatibility of the objectives of decentralization and agricultural development resulted in a bifurcation between those advocating sectoral readjustments through recentralization and planned investment and those arguing that further expansion of market forces would promote greater productivity. However, because centralization stymied microeconomic performance and decentralization thwarted macroeconomic stability, neither was able to provide a satisfactory solution to China's economic predicaments. Moreover, the development of a market economy had precipitated the appearance of novel economic problems—most pressingly mounting inflation.

The inability of the extant paradigm—centered on the analysis of sectoral relations and the laws of value and planned, proportionate development—prompted a search for novel alternatives amongst China's economists. Such an alternative had begun to take shape by the mid-1980s. These initial discussions, building on antecedent debates of pricing and the law of value, reflected the opinion that, through economic levers, such as price controls and taxation, the state would be able to indirectly coordinate productive efforts. This would ensure economic development would unfold in accordance within the Party's objectives while fiscal and operational autonomy would invigorate enterprise. This perspective was explicitly endorsed in 1984, when the state engaged in a comprehensive program of price liberalization. Reform, however, experienced a considerable setback when arbitrary differences in plan and market prices and soft budget constraints promoted rent-seeking among SOE, and excessive demand for capital caused severe inflationary pressure and a rapid decline in the fiscal capability of the central state.

The novel problem of inflation caused economists to take an interest in monetary and Keynesian theory. Compatibility with the Marxian analysis provided an initial breeding ground for these Western streams of economic thought—monetarism in particular. The emphasis within these theories on monetary and fiscal policy dovetailed with the state's novel orientation toward macro-control, prompting an increasing reliance on manipulation of money and credit supply. However, absent the separation of state and enterprise and the removal of price differences, attempts to maintain macroeconomic balance by way of indirect measures proved ineffective. As long as public ownership of the productive forces remained the principal substantiation of the socialist character of the Chinese economy, profound changes within state industry were impossible. Additionally, as demonstrated by the policies of Li Peng, conservative leadership continued to adhere to an essentially socialist framework, which considered inflation to ultimately cause sectoral imbalances. Throughout the first phase of reforms, policy remained characterized by the

periodic alternation of decentralization and consolidation, causing economic development to progress by starts and fits.<sup>134</sup> Nevertheless, much like the debate on adjustment and the reform of the 1960s had laid the foundation for the changes introduced by Deng, the discussion of the 1980s would provide much of the theoretical input for economic policy in the subsequent decades.

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134 This see-saw process of reform and consolidation has been characterized by Richard Baum (1994) as a cycle of *fang* (releasing) and *shou* (contraction).

# The Emergence and Development of the Socialist Market Economy (1992–2003)

## Introduction

Political and economic developments in the late 1980s and early 1990s proved decisive for the subsequent course of economic development. Within just a few years the economic reform faction lost many of its most ardent and influential proponents. The progressive cohort, headed by Zhao Ziyang and Hu Yaobang, had been held responsible for the arousal of liberal (*ziben zhuyi*) sentiments among the public and ensuing events at Tiananmen. Their forceful removal from the political sphere bolstered conservative influence, which had already been on the rise since the inflationary crisis of 1988. Indeed, from then on out, the leadership developed a strong consensus that China's political and economic stability hinged crucially on a powerful and expansive central state. Nevertheless, by 1991 the mantra of extended planning, promoted by conservative first-generation leaders such as Li Xiannian and Chen Yun, had proven to be an unfeasible alternative to reform (Naughton 2009). While central controls over prices and credit had managed to curb industrial investments and mitigate inflationary pressures, they proved a blunt instrument. Even as production rebounded, central restrictions constrained demand, causing economic stagnation and damaging the prospect of realizing the objectives of quadrupling China's GDP, set out under the twelfth Party congress. Any possibility of reverting to the conservative model wherein the market played but a supplementary role was expunged when Deng initiated the "second liberation of thought" during his southern inspection tour in 1992. Although, subsequently, China's indigenous variety of socialist thought was employed to justify the role and remit of the state, its function as a cognitive framework for economic policymaking was waning.

The rejection of the conservative economic template was accompanied by a search for novel ways to realize the objectives of continuous economic growth and macroeconomic stability. From the 1990s onward, economic growth would no longer be intrinsically associated with the comprehensive devolution of authority, nor would economic stability be equated with an expansion of central planning. The alternative that began to take shape under the new leadership of Jiang Zemin and Zhu Rongji rather focused on the delineation of ownership

and property rights in the public economy. The resultant system of the socialist market economy (*shehui zhuyi shichang jingji*) would be characterized by the predominance of public ownership combined with free competition among enterprise and market allocation of capital. However, no sooner did economic leadership begin to establish the institutional foundations of this novel system than policymaking took a radically different direction. Rather than emphasizing the restructuring of property rights and free factor markets, reforms would come to focus on the redistribution of capital across central and local government and the private economy. Consolidation of central control over fiscal policy and finance bolstered the financial capacity of central government and the industrial conglomerates under its purview.<sup>135</sup> Concurrently, readjustment sought to boost the efficiency of stagnant public industry through the divestment of loss-making SOE and the development of scale economies in upstream state-controlled sectors. This strategy of “grasping the large and releasing the small” (*zhua da fang xiao*) invigorated public industry and provided great impetus to the development of the private economy, leading both domestic and foreign observers to consider it a major advance toward the establishment of a liberal economic system. However, rather than asserting China’s course toward a more liberal economic system, the leadership’s reinterpretation of the principles of reform and readjustment heralded the vindication of a neo-authoritarian paradigm, strongly focused on the preservation and expansion of central control.

### The Second Liberation of Thought and the Marginalization of Socialist Diagnostics

In the immediate aftermath of the Tiananmen debacle, centralist measures to control soaring inflation were accompanied by a more general reemergence of socialist ideology (Lieber 2013). Although poor economic results in the early 1990s undermined the legitimacy of the conservative program, the program continued to dominate economic discourse. The most marked expression of conservative influence was the debate on the “capitalist” or “socialist” genealogy (*xing zi xing she*) of reforms. In early 1990, the *People’s Daily* published an article by Wang Renzhi, head of the Central Department of Propaganda (*zhongyang xuanchuan bu*). The article explicitly juxtaposed reforms of a

135 Notably, central leadership’s decision to proceed with fiscal reforms was strongly influenced by a 1993 report by neo-authoritarian academics Hu Angang and Wang Shaoguang on the progressive weakening of the power of the central state. See Wang and Hu (1993).

capitalist and socialist nature, stating that the former would “annul the dominant position of public ownership and bring about privatization; and dissolve the plan economy and cause marketization.” According to Wang, privatization and marketization would inevitably bring on the reemergence and rapid proliferation of the capitalist class (Wang 1990). Wang’s argument inspired a spate of conservative articles, insisting that an appraisal of the socialist quality of proposals should be the first and decisive criterion in economic policymaking.<sup>136</sup>

The conservative emphasis on socialist genealogy drew criticisms from both the political domain and academia. Publications in the *Jiefang Ribao* [*Liberation Daily*], based in reform-oriented Shanghai, warned against conservative dogmatism, stating that “plan and market are merely two mechanisms of resource allocation, and do not signify a delineation between socialism and capitalism; there is planning under capitalism, and market [allocation] under socialism” (Huang 1990).<sup>137</sup> These concerns were reiterated at an academic conference hosted by Chinese Academy of Science (*zhongguo kexueyuan*) in July 1991. Prominent economists such as Liu Guoguang, Wu Jinglian and Dai Yuanchen warned that an undue focus on the socialist or capitalist character of economic policy would hamper socialist development.

Despite these objections, the leadership’s preoccupation with the preservation of public ownership and central planning continued to obstruct the progress of reform. Perturbed by the dominance of the conservative perspective, Deng Xiaoping made a series of impromptu appearances in the southern cities of Guangzhou, Zhuhai and Shenzhen in January and February 1992, seeking to secure official support for reforms.<sup>138</sup> During these “southern inspections” (*nan xun*), Deng admonished that the real danger to socialism consisted not of the eventual permeation of certain capitalist elements, but rather the apparent reemergence of leftist tendencies (Deng 1992). He explicitly renounced the practice of examining the socialist provenance of policies, arguing that the merit of reforms rather ought to be determined on basis of their contribution to the development of the productive forces, the livelihood of the Chinese people and the prowess of the socialist state.

While Deng’s political stature prevented predominantly conservative leadership from explicit condemnation, the center initially remained mute on the

136 These articles appeared predominantly in Beijing-based publications such as *Renmin Ribao* [*People’s Daily*], and *Dangdai Sichao* [*Modern Zeitgeist*]. See *Renmin Ribao* (1990a; 1990b); *Dangdai Sichao* (1990, pp. 3–5).

137 Deng said exactly the same during his “southern inspection.” See Vogel (2011, p. 673).

138 Deng had chosen his itinerary in strategic manner; each of these cities had been designated a SEZ in the 1980s and was therefore at the forefront of reforms.

topic of the southern tour (Vogel 2011). Excerpts of Deng's speeches were, however, widely circulated through unofficial channels, and met with widespread approval. Economic stagnation prompted popular support for the continuation of reform. Moreover, in the aftermath of the Tiananmen popular uprising of 1989, Deng's condemnation of the ideological overtones of conservative program—evoking parallels with the Cultural Revolution—struck a chord with many within the Party-state apparatus. The accelerating momentum of the progressive movement coincided with the death of the conservative Li Xiannian, who had been instrumental in Jiang's elevation to the political center. Subsequently, Jiang, seeking to consolidate his position as Deng's heir apparent, urged leaders to accelerate the pace of reform. Deng's three criteria for reform were canonized as the "three merits" (*san ge you liyu*), officially putting an end to the discourse on the socialist and capitalist genealogy of economic policies.

The defeat greatly weakened the conservative faction and socialist ideology's place in the economic policy paradigm. Once again Xue Muqiao joined the debate and observed that in the first decades of the PRC, revolutionary change of the relations of production had generally preceded the transformation of the productive forces. Such attempts to transcend the law of value and abolish the commodity economy had stood in direct contradiction to Marx's method of historical materialism. Marx had stipulated that changes in the relations of production are conditioned by the development of the productive forces (Xue 1992; see also Liu, G. 1992).<sup>139</sup> Xue's argument thus amounted to a repudiation of the teleological interpretation of Marxism in favor of a historical determinism, wherein changes in the regulation of production were dictated by extant constraints on economic development. Changing the relationships of production on the basis of whether they seemed to correspond better to the ideal socialist economy would likely only result in imbalances between the superstructure and the extant state of productive forces. Wrote Xue: "In evaluating the merits of any productive relationship or economic system, we ought to

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139 The method of historical materialism is reflected in what Marx presents to be the general conclusion to his study of the political economy: "In the social production of their existence, men inevitably enter into definite relations, which are independent of their will, namely relations of production appropriate to a given stage in the development of their material forces of production. The totality of these relations of production constitutes the economic structure of society, the real foundation, on which arises a legal and political superstructure and to which correspond definite forms of social consciousness. The mode of production of material life conditions the general process of social, political and intellectual life. It is not the consciousness of men that determines their existence, but their social existence that determines their consciousness" (Marx 1904, p. 2).

judge not on its [ideological] virtue, but rather on whether it expedites the development of the productive forces and improves the livelihood of the people" (Xue 1992, p. 6).

This second liberation of thought, ushered in by Deng, paved the way for a second generation of Chinese economists, influenced more by Western monetarism and theories of the firm than the Marxian analysis which had inspired the discourse in the previous era. Later, the liberal slant of economic discourse would be counterpoised by a political neo-authoritarianism, influenced by the economic and social instability of the latter years of the 1980s. The coalescence of forces for market and firm-centric reform and the consolidation of central influence prompted a series of profound changes to the Chinese economic system, resulting eventually in an idiosyncratic amalgam of capitalist institutions and bureaucratic controls. However, in the period immediately following Deng's southern tour, the emphasis was unequivocally on enterprise and market reform.

### Ownership, Interest and Property Rights

In the second half of the 1980s, economic analysis had undergone a gradual shift from the examination of general sectoral relations toward an enterprise-centric mode of economic analysis. Economic discourse had revolved around the optimization of the contract responsibility system and the rationalization of external conditions which introduced arbitrary differences in enterprise performance. In the late 1980s and early 1990s, the government had experimented with the introduction of a tender system (*zhaobiao chengbao*)—whereby parties could compete for the right to manage SOEs—and profit-sharing arrangements (Liu, Sullivan and Jinglian 1995). Both were intended to incentivize management. However, the state had retained authority over long-term investments and the organization of assets, constraining managerial decision-making, and limiting enterprises' ability to respond to changing market conditions. Moreover, because management could easily divert state capital to wages and other benefits, profit-based incentives failed to adequately motivate productive behavior.

The persistent problems of the contract responsibility system convinced a growing number of economists that the inefficiencies within SOE resulted from an incomplete definition of property rights. Without a clear understanding of the respective boundaries of state and enterprise, decisions about the distribution of operational and financial authority resulted in long and protracted bargaining. The debate on property rights and ownership reform had commenced

in the second half of the 1980s, but had subsequently been suspended during the revival of socialist orthodoxy in 1989. However, following the second liberation of thought, interest in Western theories of property right proliferated. Property rights stipulate an actor's prerogative to possess, utilize, transfer and dispose of property. Moreover, such rights hold actors accountable for the economic consequences (i.e. costs and benefits) of their use of property. This last condition becomes crucially important when different actors interact over the course of using property, either directly—by engaging in transaction—or indirectly—by operating within a common space (Furubotn and Pejovich 1972). In such instances, the use of a resource by one actor generally creates benefits or detriments for the other party (Demsetz 1967).<sup>140</sup> A central concern of the property rights theory is how to deal with the distribution of these secondary costs and benefits in a manner that promotes optimal efficiency.<sup>141</sup>

Some Chinese economists maintained that property rights theory was of little use. How, asked Gao Hongye of Renmin University, could property rights theory—assuming an economy of enterprising, asset-owning individuals—inform the debate on the problems of publicly owned industry (Gao 1991)? Proponents retorted that, irrespective of their public or private nature, enterprise assets were subject to two sets of rights, ownership rights (*suoyou quan*) and property rights (*chanquan*).<sup>142</sup> Duan Yicai argued that while ownership rights confer the benefits and liability for losses associated with assets, and the right to appoint and dismiss management, property rights provide the authority to determine the use of those assets (Duan 1992). Ni Jixiang suggested that an important step would be to separate state and enterprise ownership by transforming enterprise in legal entities with rights only to registered capital (Ni 1992). In this manner, corporatization would ensure enterprises

140 Examples of such externalities are the use of radio spectrum by one broadcaster, which interferes with the broadcast of another party, or environmental damage caused by pollution due to industrial production, see (Coase [1960] 2013).

141 According to Coase, under perfect market conditions bargaining between relevant parties will ensure an optimal outcome. For example, if the loss of proceeds from interference would have been greater for the broadcaster than the income derived by the other party, the former would have an incentive to pay the latter to cease interference (Coase [1960] 2013). The “Coase theorem” received considerable attention in Chinese scholarship, see for example Liu and Ping (1988) and Yang (1989). However, since the Coase theorem requires strict assumptions of frictionless exchange (i.e. no onset of contracting costs), it was widely considered inapplicable, see Gao (1991) and Duan (1992).

142 Note that the distinction between ownership and property rights is one particular to Chinese discourse. However, the distinction between “principal” and “agent” was introduced by Jensen and Meckling in their “Theory of the Firm” in 1976.



would no longer face the soft budget constraints that existed under the contract responsibility system. Nevertheless, potential conflicts of interest would continue to exist. The investment of the right to ownership in the state and devolution of the right to property to enterprise still allowed managers to use assets under their control for purposes other than the maximization of profits. Such residual losses could be prevented through stringent monitoring of an agent's actions by the principal, or by introducing incentives that aligned the interests of principal and agent (Jensen and Meckling 1976). However, argued Wang Xinbo of the Chinese Academy of Science, due to the imperfect specification of ownership rights under the soft budget constraint, both government agencies and banks had expended but little effort to monitor the activities of management. Accordingly, improving the quality of supervision depended on the full investment of ownership rights (i.e. *suoyouquan*) in those investing entities (Wang 1992). Alternatively, according to Liu Shijin, by tying managerial remuneration to the financial performance of enterprise, the interests of agents and principals would be aligned (Liu, S. 1992). Whether the state ought to emphasize increased supervision or the provision of incentives would depend on the cost-effectiveness in reducing managerial non-productive activity. Yang, however, opined that if the marginal costs of supervision and incentive alignment surpassed the marginal returns from reduced managerial usurpation, the state might be better served by awarding managers the right to residual claims by renting or leasing state property to managers (Yang 1992).<sup>143</sup>

While the promulgation and implementation of ownership rights hinged primarily on changes to the structure of enterprise, the full development of property rights required further systemic reform. Liu Shijin underlined that, after all, the ability of management to freely attract, utilize and divest assets depended not only on the elimination of state interference in management, but also on the proper functioning of markets. Since the assets of SOE were not transferable, their value was not determined by the market, but rather on a basis of discretionary appraisals of management and state organs. Management, instead of being able to attract capital by selecting the most favorable of market offers, had to engage in protracted negotiation with its principals. The lack of a labor market similarly impeded factor trade and thereby curbed managerial property rights (Liu, S. 1992). Although the “iron rice-bowl” system, under which enterprise guaranteed the positions and social security of workers, had

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143 The residual claimant is the beneficiary of the profits realized after financial obligations to parties providing capital inputs are satisfied. In this view the owners (i.e. the state) would simply be compensated for their provision of financial capital; see Alchian and Demsetz (1972).

been nominally terminated after the implementation of the 1988 Enterprise Law, workers' benefits could not be transferred between firms, and labor had essentially remained immobile.

All in all, the measures proposed by Chinese adherents of property rights theory constituted a considerable departure from the contracting-based arrangements that had developed out of the market reforms introduced by Deng in 1979. The increasing traction of these new ideas in academic discourse coincided with major changes in central politics, driven by the greatly diminished status of the conservatives and the retirement of the second-generation leadership. Jointly, these developments provided the conditions for the promulgation of the concept of the socialist market economy.

### The Formulation of a Socialist Market Economy

At the fourteenth Party congress, held in October 1992, Party leadership convened to charter the development of the Chinese economic system. The guiding principle was provided by the new concept of the socialist market economy.<sup>144</sup> In his address to the Party assembly, General Secretary Jiang Zemin reiterated the ideological tone of Deng's southern tour. Condemning the untoward preoccupation of conservatives with the socialist or capitalist character of policy, Jiang emphasized that within the primary stage of socialism, resolution of the "major contradiction" between the growing material needs of the people and the backward state of the productive forces was imperative. Under the new system, the market would play the primary role in the development of the productive forces. Competition and market prices would guide procurement and production in both public industry and the commodity economy. Additionally, the state would persist with the devolution of financial and operational responsibilities to enterprise. At the micro level, marketization and corporatization would instill greater economic discipline within enterprise, while at the macro level the shift from a supply- to a demand-driven economy would ensure that production corresponded to societal need and prevent overaccumulation. In keeping with "to each according to one's labor," market allocation would increasingly determine labor supply and wages too.

Specific measures were articulated during the third plenary session of October the following year. During the plenum, the Central Committee promulgated the "Decision on Certain Issues within the Establishment of the

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144 The concept of the socialist market economy was enshrined in the Constitution on March 29, 1993.

Socialist Market Economy.” Actively promoted by Zhu Rongji, then governor of the People’s Bank of China (PBC) (Lau 1999), who had been recently elevated to central politics, the document, encompassing enterprise, market and regulatory reforms, constituted the most comprehensive reform since 1978. The cornerstone of the Decision was the modern enterprise system (*xiandai qiye zhidu*), which would replace the contract responsibility system. The new system introduced three major changes to enterprise governance. First was the specification and separation of ownership and property rights. The state would retain the ownership rights to public assets in large and medium-sized enterprises, while the enterprise as a legal entity would hold the property rights to all investor equity, including that held by the state. Investors could participate in major decisions—such as managerial appointments—and would enjoy the right to profits in a manner proportionate to their total share of capital. All companies operating under the new system would adopt a tripartite governance structure, composed of the shareholder’s committee, management board and a supervisory board elected by enterprise workers. These boards replaced the “old three committees” (*lao san hui*), composed of worker representatives (*zhigong daibiao hui*), labor union spokesmen and the enterprise Party committee. Most small SOEs would continue to operate under the contract responsibility system, while a minor portion could be transformed into privately or collectively owned shareholding cooperatives (*gufen hezuo qiye*).<sup>145</sup>

Management would be held solely responsible for the operation of enterprise and its losses and benefits. Second, investors would only be financially liable for capital invested. Finally, enterprises were to unequivocally pursue profit maximization through market production, and the government was to refrain from interjecting additional objectives or otherwise interfering in the operation of enterprise. Structurally insolvent enterprises were to be disbanded in accordance with the Bankruptcy Law of 1986.<sup>146</sup> Corporate transformation was a crucial prerequisite to the delineation of fiscal and operational rights and responsibilities. SOEs would take on one of a variety of legal forms. Backbone enterprises (*gugan qiye*) in pillar industries (*zhizu chanye*) would be organized as sole proprietorships under the central state. Other enterprises would be restructured as either limited liability or limited shareholding companies, and could allot equity to non-state constituencies. As such, the corporatization process would give rise to a pluralized system, characterized by the concurrent existence of state, private and mixed ownership.

145 “Zhonghua renmin gongheguo gongsifa” (1993, ch. 2).

146 “Guanyu jianli shehui zhuyi shichang jingji tizhi ruogan wenti de jue ding” (1993, ch. 2).

In tandem with enterprise reform, the Decision sought to greatly extend the scope of market allocation. In order to promote the productivity of enterprise and provide a competitive environment, fiscal subsidies and regulatory barriers were to be eliminated. The dual-track pricing system, under which certain state enterprises enjoyed discounted prices for key inputs, would also be phased out. The various preferential policies by which provincial government and industrial ministries had supported enterprises under their patronage would also be abrogated. Under the system of the socialist market economy, the allocation and pricing of capital, land and labor would be chiefly determined by forces of demand and supply. The transition from administrative control to market regulation furthermore required the comprehensive reorganization of the financial system. The PBC, whose main function had been the fulfilment of the state's credit plan, was to assume to role of central bank with responsibility for monetary policy. To further promote the independent operation of the financial markets, policy and commercial lending were to be separated. In order to allow enterprises to autonomously attract and divest labor, the extant firm-based welfare arrangements would be replaced with a nationally administrated social security system wherein workers' benefits would be transferable.<sup>147</sup>

The third major element of reforms outlined in the Decision concerned the functions of government. In principle, the state was to confine itself to the regulation of the macro economy, ensuring rapid and stable growth and appropriate development of public industry. Accordingly, its main activities comprised the construction of key economic capital, social redistribution, market regulation and the supervision of state assets.<sup>148</sup> The introduction of a uniform tax system would bridge the objectives of enterprise reform and macroeconomic regulation. By adopting standardized taxes, arbitrary differences in enterprise performance would be eliminated.

Following the third plenary session the debate on the "contents and essence of a modern enterprise system" continued among Chinese economists. Chen Dongqi, of the Chinese Academy of Social Sciences, stated that "the major battlefield for 1994 and future economic reform is in the state-owned enterprises, that is, converting the current state-owned enterprise system into a modern enterprise system."<sup>149</sup> Shan Shan, also of the Chinese Academy of Social Sciences, argued that the basic components of the modern enterprise systems were: (a) a legal-entity system whereby enterprises themselves are

147 Ibid., ch. 2.

148 Ibid., ch. 3.

149 Chen (1994).

responsible for their profits and losses; (b) an enterprise leadership system characterized by vertical delegation of power; (c) a standardized financial and accounting system; (d) an enterprise income distribution system which benefits all concerned; and (e) an enterprise personnel and labor system whereby employment is based on two-way choice between the employer and employee.<sup>150</sup> Echoing the debate leading up to the third plenary session, Hu Deqiao, from the State System Reform Commission, stated that property rights reform was the crux of economic system reform,<sup>151</sup> and Bai Yingzi, of the State Economic and Trade Commission's Enterprise Corporation, wrote that a hundred state enterprises had already been selected to function as pilot units for practicing a modern enterprise system.<sup>152</sup> However, Shi Zhonglai, writing in *Zhenli de zhuiqiu*, claimed that while reform was necessary, the predominant role of public ownership should not waver.<sup>153</sup> In the same journal Yan Si, quoting Deng Xiaoping, also argued that public ownership should be regarded as the mainstay of the economy.<sup>154</sup> Yan Si further stated that there had never been a "mixed economy as the mainstay. If the mainstay is not private ownership, then private ownership is."<sup>155</sup>

The majority of the participants in the debate were of the opinion that in order to introduce clearly defined property rights, it was necessary to separate government administration from enterprise management.<sup>156</sup> Thus, Zhong Zuijian argued that the separation of Party and government functions was a key principle that should be adhered to by the ruling party.<sup>157</sup> Representing a Task Force on Comprehensive Plan for Chinese Economic System Reform, Lou Jiwei and Li Keping agreed that enterprises should be separated from direct administrative and government control.<sup>158</sup> However, Fang Xiangdong of the State Statistical Bureau stated that state enterprises should be directly operated by the state and that "one cannot artificially allow the operating rights in a state-owned enterprise to be separated from ownership right for the sake of changing the enterprise operating mechanism."<sup>159</sup> Moreover, Li Jian wrote that a recent investigation showed that opinions on the issue varied, as

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150 Shan (1994).

151 Hu (1994).

152 Bai (1994).

153 Shi (1993).

154 Yan (1994).

155 *Ibid.*, p. 11.

156 See Shan (1994).

157 Zhong (1993).

158 Lou and Li (1993).

159 Fang (1993, p. 5).

“some comrades” advocated the principle of “one shoulder carries,” that is, the principle of merging party and management functions in large SOEs in one person.<sup>160</sup>

Taken together, the micro and macroeconomic measures enumerated in the Decision represented the culmination of the debates on price and enterprise reform that had commenced in the second half of the 1980s. Those discussions had been born out of the recurring imbalances that had accompanied economic growth under Deng. However, due to disagreement about the relative importance of price rationalization and the reorganization of enterprise—not to mention the persistent challenge of the conservative faction—reform-oriented economists and leadership had failed to clearly articulate the relation between production and regulation and the roles of government and enterprise. The proclamation of the socialist market economy constituted a major advance toward the development of a novel economic paradigm. While in the initial era of reform, economic discourse had still emphasized sectoral relations and planned, proportionate development, policy and discussion in the first half of the 1990s had a strong neoclassical quality. In the conception articulated during the fourteenth congress, the focus on macroeconomic control had been supplanted with an emphasis on microeconomic efficiency. Optimization of production and exchange would depend on the establishment of institutional conditions (and first and foremost, the establishment of clear property rights) that allowed enterprise to pursue profit maximization (Liu, S. 1992; Wang 1992), and remove obstacles to efficient market exchange. The increasing traction of neoclassical theory amongst academics and policymakers did not, however, imply that the state envisioned the gradual retrenchment of the public economy. In his address to congress, Jiang stated that “the system of public ownership—including collective ownership—should comprise the major component, and the individual, private and foreign invested economies are complements.”<sup>161</sup> Thus, the objective of the resolutions of the fourteenth congress were not privatization per se,<sup>162</sup> but rather an organizational

160 Li (1993).

161 Chapter 2 of the Decision defines public ownership of the means of production as the fundamental characteristic of socialism, stating that: “the socialist market economic system is bound together with the basic system of socialism. To establish the socialist market economy is let the market perform its fundamental allocative function under the macroeconomic control of the state. So as to achieve this objective, we must persist in retaining public ownership as the major element.”

162 Note that the Chinese state itself has refrained from using the term privatization (*sìy-ouhua*), which to the present day has continued to have negative connotations. Rather,

transformation of the public economy, consisting mainly of corporatization and progressive expansion of market forces in production, industrial relations and finance. All in all, the reforms advocated by the new leadership were conceptually closer to the notion of market socialism, as advocated by Lange,<sup>163</sup> than any pure form of liberalism.

*Fiscal and Monetary Reform and the Reinvigoration of the Central State*

In the years following the third plenum of the fourteenth congress, a continual series of novel regulations was introduced to realize the establishment of the socialist market economy. In accordance with the prevailing economic discussions, initial emphasis was on the introduction of the modern enterprise system. The Company Law,<sup>164</sup> issued in late 1993, required large and medium-sized enterprises to convert to limited liability companies. Although operational authority, including responsibility for profits and losses, had been nominally devolved onto management, the introduction of the modern enterprise system failed to promote a significant upturn in the productivity of public enterprise. Progress with the corporatization of enterprise was slow, particularly within large, centrally controlled enterprises. Even in those firms that operated under the modern enterprise system, results were limited. Although direct state subsidies to loss-making enterprises were scaled back after the introduction of the new system,<sup>165</sup> banks, pressured by local government, had continued to funnel capital to state firms (Steinfeld 2002). As such, the soft budget constraint persisted. Not only had the introduction of the modern enterprise system failed to alleviate the burden of loss-making enterprise, but the state's financial prowess had severely weakened. The removal of price controls had depressed industrial profits, and the introduction of the contract responsibility system had decreased remittances to the government (Brandt and Zhu 2000; Naughton 2009). Moreover, due to fiscal decentralization, local government had been able to negotiate the transfer of revenues to the center, and central revenues had remained consistently low during the period of reform.

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the state has referred to the divestment of its assets by use of such phrases as “transformation of the ownership system” (*suoyouzhi gaige*).

- 163 Lange advocated a system of public ownership wherein production and exchange would be predominantly regulated by the market, but the state would play a major role in the distribution of surplus value, see Lange (1937).
- 164 “Gongsifa” [Company Law] (December 1993).
- 165 In 1990, subsidies to loss-making enterprise had accounted for 19.7 percent of state expenditure. By 1994, this proportion had been reduced to 7.02 percent NBS (2005, tables 16, 18).

Not only did the marginalization of state revenues render it increasingly difficult to support insolvent public industry, the limited fiscal authority of the center also constrained its capacity for macroeconomic adjustment. The issue of central control once again rose to prominence due to the serious economic imbalances that appeared in late 1993. Deng's exhortations for the unimpeded continuation of economic development had inspired a new spate of uncontrolled local government investment (Shirk 1993; Wu 2005). Investment in industry resulted in excessive demand for producer goods, driving up prices. Local government investment was financed in large part through bank credit, resulting in a rapid expansion of the money supply (Ma 1996). Jointly, these factors caused inflation to soar (Chang and Hou 1997).<sup>166</sup>

Eager to placate economic volatility, the central state rapidly proceeded with the proposed changes to fiscal and monetary policy. The "Decision on Management of the Fiscal System," introduced in late 1993, abrogated the convoluted and ambiguous arrangements that had existed under the fiscal responsibility system. The number of taxes was reduced, and remaining tax rates were standardized. Income taxes for medium and large-sized SOEs were fixed at a uniform 33 percent, 30 of which was remitted to central government.<sup>167</sup> Additionally, the Decision clearly delineated central and local sources of fiscal revenue. Proceeds from taxes on foreign goods, central enterprise, and banks and insurance firms (including local branches) would belong to the center. Local government's main sources of fiscal revenue were constituted by taxes of capital and income of enterprises other than those controlled by the center, personal income tax and proceeds from leases of urban land. Revenues from domestic value-added tax would be shared, with the center obtaining 75 percent and localities 25 percent.<sup>168</sup> As a result of the tax reforms, central fiscal revenues rapidly increased, eliminating the fiscal imbalances between center and locality (see Table 6).

Higher and more extensive value-added tax and newly introduced taxes on consumption service enterprises jointly accounted for approximately 70 percent of budgetary revenues in 1994 (Ma 2000, p. 19).

Concurrent efforts were made to curtail the availability of credit by consolidating monetary authority within the PBC. Under the guidance of Zhu Rongji,

166 In 1993 and 1994, the gross value of industrial output rose by 27.3 and 24.2 percent, while inflation rose by 14.7 and 24.1 percent respectively (NBS 1999, tables A-20, A-33).

167 However, transitional allowances were made for enterprises under severe economic pressure. See "Guaojia tiwei yougan bumen jiu 1994 gaige yu fazhan wenti daben kanji zhe" (1994, pp. 11–13).

168 "Guanyu shixing fenshuizhi caizheng guanli tizhi de jue ding" (1993, ch. 2).



TABLE 6 *Fiscal revenues, 1990–1995*

	Fiscal revenue, YoY growth (%)	Central/local fiscal revenue (%)
1990	10.2	51.0
1991	7.2	42.4
1992	10.6	39.1
1993	24.8	28.2
1994	20.0	125.7
1995	19.6	109.1

SOURCE: NBS (2005, TABLES 15, 23).

NOTE: YOY = YEAR ON YEAR.

the “Decision on Reform of the Finance System” was promulgated in late December 1993. The Decision provided the People’s Bank with de facto central bank status.<sup>169</sup> From then on, the PBC’s chief responsibility would be to control the money supply in order to maintain currency stability and promote steady growth. Open market operations,<sup>170</sup> discount rate adjustments,<sup>171</sup> and stipulation of reserve ratios would constitute the bank’s main tools. Additionally, in order to put an end to the undue influence of provincial governments over the PBC, the bank’s local branches were to be replaced by six regional organs.<sup>172</sup> Fiscal and monetary measures proved effective at restoring economic stability; fiscal recentralization curbed local governments’ discretionary investment in capital construction, and the consolidation of authority in the People’s Bank and its regional departments centralized control over the money supply. As a result, the investment frenzy abated, and inflation decreased in tandem.

More institutional changes followed throughout 1994 and 1995. In accordance with the recommendations of China’s property rights economists, the state forged ahead with reforms of the financial and social security systems.

169 A status subsequently formalized in People’s Bank of China Law [*Zhongguo renmin yinhangfa*], (March 1995).

170 Open market operations are the sale or purchase of state securities that the central bank undertakes in order to expand or contract the money supply.

171 The discount rate is the interest rate at which the central bank extends credit to other banks.

172 “Guanyu jinrong tizhi gaige de jueding” (1993).

TABLE 7 *Indicators of fiscal and monetary policy and inflation, 1991–1996 (%)*

	Government capital construction/GDP	Mo growth*	Consumer price index	Price index, investment in fixed assets
1991	2.59	20.2	3.4	9.5
1992	2.09	36.4	6.4	15.2
1993	1.71	N/A	14.7	26.6
1994	1.37	24.3	24.1	10.4
1995	1.35	8.2	17.1	5.9
1996	1.36	11.6	8.3	4.0

\* Mo refers to the narrow money supply, that is, cash and assets that can be quickly converted into currency.

SOURCE: NBS (2007, TABLES 3-1, 8-4, 9-1, 20-7).

In an effort to harden budget constraints and put a halt to mounting non-performing loans, commercial (*shangyexing*) and policy (*zhengcexing*) lending were separated. From March 1994 onward, policy lending became the purview of three newly established institutions: the State Development Bank (*guojia kaifa yinhang*), responsible for state investment of capital construction, the Import-Export Bank (*zhongguo jin chukou yinhang*), managing foreign trade, and the Agricultural Development Bank (*zhongguo nongye fazhan yinhang*) (see Nanto and Sinha 2002). In May 1995, the Commercial Banking Law delineated the activities of China's specialized banks (*zhuanye yinhang*). Under the new law, commercial banks were to function as corporate entities. In order to fulfill their fiduciary duties to depositors, banks were to engage in lending purely on the basis of prospective profitability. Additionally, in order to bring an end to the rampant speculation that had ensued following the establishment of China's securities markets,<sup>173</sup> the law required commercial banks to cease all equity investment activities.<sup>174</sup>

Attempts to rationalize the allocation of capital were accompanied by comprehensive changes within industrial relations. By way of the Labor Law, passed by the National People's Congress on 5 July, 1994, the state sought to

173 Because deposits were guaranteed by the state, China's commercial banks had faced no downside risk to speculative investment, prompting excessive speculation.

174 "Shangye yinhangfa" (1995, article 43). The Shanghai Securities Exchange commenced operation in late 1990. A second exchange was opened in Shenzhen the following year.

develop a unified labor market. Most importantly, the law greatly increased the operational authority of managers of SOE by substituting the practice of lifetime employment by a system of contract labor.<sup>175</sup> Enterprises were allowed to autonomously attract and divest workers, and set wages subject to a minimum stipulated by provincial or municipal government.<sup>176</sup> Attempts to bring the social security system in line with the goal of a unified labor market commenced in March 1995. The “Circular on Deepening Reform of the Enterprise Worker Pension System” described a new system in which individual and corporate remittances would fund a tripartite program of nationally administered basic insurance and locally determined enterprise and individual contributions. While national basic insurance would improve labor mobility, the shift toward enterprise and individual contributions sought to reduce the fiscal burden on government.

### *The Retrenchment of Public Industry and the Debate on Ownership*

Measures introduced in the wake of the fourteenth congress were successful in controlling inflation and restoring the fiscal strength of the center. However, progress within the pivotal area of enterprise reform had been marginal. Implementation of the modern enterprise system had unfolded but slowly and haphazardly.<sup>177</sup> Even in those enterprises that operated under the new corporate governance system—and thus were nominally subject to the control of shareholders and supervisors—implementation had been an instance of form over matter, because the state had retained full ownership of enterprises. Due to its monopoly over corporate control, local government and ministries could continue to insert objectives that detracted from the optimization of enterprise productivity. The only manner to effectively deal with the adverse influence of special interests, argued Wu Jinglian, of the Development Research Center (*fazhan yanjiu zhongxin*), was through ownership diversification (Wu 1994). However, poorly performing enterprises, which arguably stood to benefit most from increased shareholder scrutiny and the clear delineation of ownership rights, were exempted from the conversion to diversified shareholder corporations (Hu 1994). In December 1993, He Guanghui, vice-director of the State Economic Reform Commission (*guojia jingji tizhi gaige weiyuanhui*), had

175 “Laodongfa (July 1994, ch. 3).

176 *Ibid.*, ch. 5.

177 In 1994, the central government decided to commence implementation of the modern enterprise system on a trial basis in a small group of enterprises. The government planned to decide how to proceed on the basis of an appraisal of the outcomes at the end of the experimental period in 1997. *Zhengfu gongzuo baogao* (1994).

given priority to reform of “profitable and highly productive large enterprises,” which could, “in accordance with the direction of industrial policy, be directly reorganized as state controlled or state participated limited liability shareholding companies” (He 1993). Although the State Economic Reform Commission had been among the earliest and most ardent proponents of the modern enterprise system (Beijing Xinhua 1993),<sup>178</sup> it was likewise concerned about the additional pressure ownership restructuring would exert on the enfeebled public industry.<sup>179</sup> Due to changes in taxation and the tightening of lending policies, a large portion of public enterprise was ill-equipped to assume full financial responsibility. In any case, considerable doubt remained as to the degree to which China’s embryonic equity markets could instill greater discipline in listed enterprises. Although external shareholders had been instrumental in relieving pressure from China’s banks by providing an alternative source of capital, investors lacked the expertise or information to engage in scrupulous supervision of enterprise, and investment in China’s emergent securities market had been highly speculative. Accordingly, Wu Jinglian argued that ownership diversification ought to be realized either through a domestic transformation process (*judi gaizao*), wherein shares would be allotted to enterprise workers and banks (whose claim to enterprise’s retained profits, pension funds and credit effectively rendered them principals), or through the attraction of foreign capital (Wu 1994). However, not only would the maturation of China’s embryonic equity market take considerable time and effort, but due to the insistence on the primacy of public ownership, there were patent limits to the degree of ownership Party-state leadership was willing to relinquish.

All in all, due to the added pressure of tax and financial reform and the complexity of change within the enterprise and its operating environment, progress with the implementation of the modern enterprise system was slow.<sup>180</sup> Nevertheless, the imminent problem of pervasive losses within public industry required a rapid response. Developments at the local level, where mounting budget deficits had prompted a spontaneous process of ownership reform, provided a new avenue for reforms. Local government had come under increasing pressure due to the 1994 tax reforms, which had resulted in the

178 Adverse economic conditions within public industry likewise convinced central Party leadership (including Zhu Rongji) that the pace of reforms ought to be slowed down. See “Jiang Zemin, Li Peng Support Zhu Rongji’s Economic Reform Stand and Measures” (1994, p. 2).

179 According to figures published by the Ministry of Finance, in the first half of 1994, 46.3 percent of SOEs operated at a loss. See FBIS-CHI-94-141 (July 22, 1994), p. 22.

180 FBIS-CHI-94-165 (August 25, 1994), pp. 36.

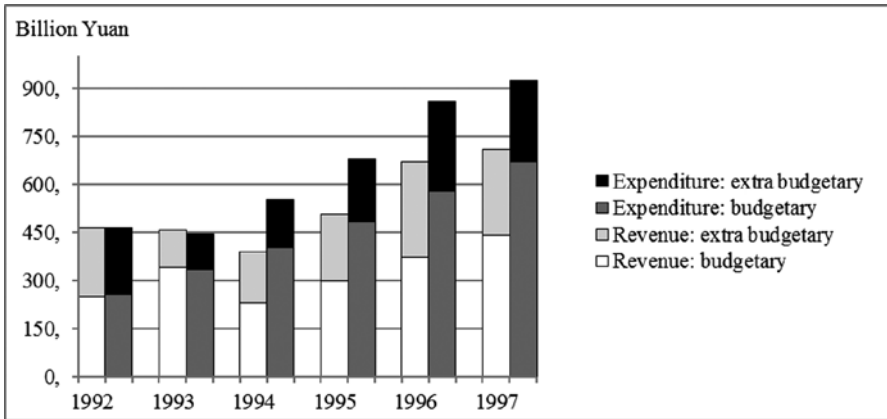


FIGURE 8 Revenues and expenditure of local government, 1992–1997.

SOURCE: NBS (2005, TABLES 23, 24).

recentralization of fiscal revenues. However, there had been no proportionate redistribution of budgetary expenses (see Figure 8).

In order to supplement fiscal revenues, provincial governments had increasingly resorted to the sale of the assets of small SOEs (Lau 1999). Despite concerns regarding the expropriation of value attending the sale of state-owned assets (Yuan 1995), privatization proceeded at a rapid pace. Indeed, by 1996 several provincial governments had divested themselves of the majority of their small SOEs (Cao, Qian, and Weingast 1999).

Local government's privatization of small public enterprise gave rise to heated debate. China's liberal economists, perceiving privatization to provide new impetus to the stagnating project of enterprise modernization, were quick to express their approval (Wu and Zhang 1995; Zhang 1995). At the same time, the developments caused a backlash of conservative criticism. Although marginalized within politics, conservatives continued to assert their influence on public discourse through such ideological publications as *Dangdai Sichao*. Through a series of "10,000 character letters" (*wan zi shu*),<sup>181</sup> the conservatives

181 Four such letters were published: "Yingxiang wo guo guojia anquan de ruogan yinsu" [Certain Factors Influencing Our National Security], dating from early 1995; "Weilai yi er shi nian wo guo guojia anquan de neiwai xingshi ji zhuyao weixie de chubu tantao" [A Preliminary Discussion on Domestic and Foreign Trends in China's National Security and Its Major Threats in the Coming Two Decades], published in the fall of 1995; "Guanyu jianchi gongyouhi zhuti diwei de ruogan lilun he zhengce wenti" [Certain Theoretical and Policy Issues with Upholding the Predominant Position of Public Ownership] in late

sought to turn the liberal tide in Beijing. One such publication warned that: “The public sector is the economic mainstay of the political power of the proletariat. The public sector not only houses China’s industrial workers but is also the main source of China’s revenue. The drop in the proportion of the public sector and the shrinking of public ownership will inevitably weaken the Party’s leading position, the authority of the central government, and the ability of the state in handling contradictions and resolving problems. Moreover, it will menace the consolidation of the proletarian dictatorship” (Anonymous 1996, p. 1428). This is because the concomitant development of the private sector would cause “the number and economic strength of the nongovernmental bourgeoisie and petty bourgeois class [to] further expand” (*ibid.*, p. 1430). As reforms encroached on what China’s urban workers had heretofore considered inalienable rights (Hurst and O’Brien 2002), such ideological critiques increasingly resonated with the general population (Misra 2003). However, changes in central policy in the latter half of the 1990s would greatly accelerate, rather than attenuate, the momentum of privatization.

### **A Turning Point in the Development of the Socialist Market Economy: From the Modern Enterprise System to Grasping the Large and Releasing the Small**

Local dynamics seemed to directly contradict the central blueprint for the socialist market economy. To be sure, the extent of privatization at the local level far surpassed the scope for the transformation of the ownership system (*zhuanzhi*) of a minor portion of small SOE allowed for by the center. However, the increasing momentum of locally initiated privatization coincided with a growing conviction among central leadership that successful reform of the entire state-owned economy would prove an unachievable feat and that big companies were necessary. The perceived limits to holistic public sector reform provided leeway for the introduction of a reform strategy that would incorporate elements of the liberal agenda, yet do so in a manner that bolstered authoritarian control. This strategy, subsequently referred to by the slogan “grasping the large and letting go of the small” was first articulated by

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1996; and “1992 nian yilai zichan jieji ziyouhua de dongtai he tedian” [Characteristics and Dynamics of the Liberation of the Capitalist Class from 1992 Onward], in early 1997. While unattributed, it is speculated Deng Liqun, head of the Small Leading Group on Work on Party History (*dangshi gongzuo lingdao xiaozu*), was closely involved in the drafting of the documents (Misra 2003).

Politburo member Wu Bangguo in 1994. In 1993, large SOEs comprised only 4.7 percent of total public enterprise, but accounted for 62.0 percent of net fixed assets and 66.7 percent of profits and taxes (Cao, Qian and Weingast 1999, p. 108). Accordingly, argued Wu Bangguo, the state ought to focus on those large SOEs, and could afford to divest of the plethora of small SOEs, many of which were unprofitable and debt-laden.<sup>182</sup>

The proposal to focus attempts at restructuring public industry on the consolidation of central control over China's large SOE struck a chord with China's conservative premier, Li Peng. The Eighth Five Year Plan, drafted under Li's supervision during the conservative interregnum of 1989–1991, stated that “the state must control the national economic lifelines, and exert a leading function in economic development (Li 1991).”<sup>183</sup> To this end, Li had consistently supported the decision to establish a small number of central business groups (*zhongyang qiye jituan*), which would secure the center's hold on China's pillar industries, such as energy, transportation and petrochemicals. Moreover, the leadership was keen on developing large conglomerates as part of a strategy of increasing China's presence within the international economy. Wu Bangguo put it this way:

Japan relies on six large enterprise groups and Korea relies on ten large commercial groupings. In the same way now and in the next century our nation's position in the international economic order will be to a large extent determined by the position of our nation's large enterprises and groups.

ORIGINALLY CITED IN NOLAN 2001, P. 122

These business groups, operating directly under State Council, would form vast conglomerates, comprised of large SOEs which would hold controlling stakes over a plethora of smaller firms. Whereas initial experiments with the development of horizontal enterprise interlinks focused on the development of economies of scale and removing undue interference from provincial and

182 While proceeds from the divestment of small SOE had supplemented provincial revenues, arguably the reduction of subsidies to loss-making enterprises was more important. In 1994, small SOEs accounted for 90 percent of all losses in public industry (Cao, Qian and Weingast 1999, p. 109).

183 “Zhonghua renmin gongheguo guomin jingji he shehui fazhan shi nian guihua he di ba ge wu nian jihua gangyao” (1991).

industrial government, initiatives in the early 1990s gave equal emphasis to the bolstering of central control.<sup>184</sup>

After the conservative program was overturned by Deng Xiaoping in early 1992, the emphasis had once again been on enterprise reform and marketization. Nevertheless, while Zhu Rongji's efforts were directed at the articulation of a modern enterprise system capable of resolving soft budget constraints and delineating property and ownership rights, Li had continued to stress the importance of the development of large SOE.<sup>185</sup> The concept of grasping the large and releasing the small, promulgated in the context of an upsurge in duplicative investment and inflation, provided an opportune occasion for the reinstatement of Li's strategy of creating a team of "national champions" (*guojia dui*).<sup>186</sup> In his government work report of 1995, Li insisted that the modern enterprise system be introduced in tandem with the restructuring (of public industry and enterprise) and technological transformation (*gaizu, gaizhi he gaizao*) (Li 1995b). The novel institutions introduced to support the development of the modern enterprise system would be instrumental in the process of industrial and corporate restructuring. Corporatization, which would transform public firms into shareholding enterprises, would greatly facilitate the process of merging state-owned assets. Moreover, the transformation of SOEs into state-controlled shareholding entities enabled enterprise groups to raise large sums of capital on China's securities exchange, further aiding their expansion (He 1993). The pressure exerted on enterprise by mounting non-performing enterprise loans—a result of the decision to convert funds to loans—could be reduced by way of debt–equity swaps, wherein the state cancelled debts in return for a commensurate portion of equity.<sup>187</sup>

Additionally, provisions for the transformation (*zhuangzhi*) or transfer (*zhuanrang*) of ownership would provide the state with concrete means for the divestment of loss-making SOEs. The momentum of local privatization picked up considerably after a delegation of senior leaders (including Zhu Rongji) made an inspection in Zhucheng in March 1996. The county-level city in Shandong province had been among the first to engage in the divestiture of

184 "Guanyu xuanze yi pi daxing qiye jituan jinxing shidian qingshi de tongzhi" (1991).

185 While Li had expressed his nominal support for enterprise reform, it seems his view thereof was more in line with the notions of modernization and technological renovation that Deng Xiaoping had proposed than with contemporary discussion of ownership restructuring, see FBIS-CHI-94-167 (August 29, 1994), pp. 27–30.

186 See Nolan (2001, ch. 3).

187 Experimentation with such arrangements commenced in late 1996. See "Guanyu zhongyangji 'bo gai dai' zijin benxi yu'e zhuanwei guojia zibenjin de shishi banfa" (1996).



its small SOE. Although Zhu had his misgivings, the inspection was widely and favorably reported by Beijing media (notably the influential *Economic Times*), exhorting many local governments to adopt the “Zhucheng model” (Wu 2001). All in all, the strategy of grasping the large and retaining the small was less concerned with the separation of state and enterprise than the consolidation and bolstering of the center’s fiscal position and its hold on China’s pillar industries.

Thus, while public debate revolved around traditional issues of public and private ownership, the central policy paradigm was steadily shifting toward a new authoritarianism. Indeed, when Li delivered the government working report in March 1997, he was able to put the consolidation of large enterprise and business groups and the divestiture of small SOE center stage. By contrast, the implementation of the modern enterprise system was assigned a role of decisively lesser importance (Li 1997). The following month, the state proceeded with the selection of a second batch of large SOEs, increasing the number of national champions to 120.<sup>188</sup> The decisive vindication of the neo-authoritarian paradigm occurred later that year. On May 29, Jiang delivered a speech at the Central Party School (*zhongyang dangxiao*) that cleared the way for large-scale ownership reform. His speech condemned the leftist deviation from the ideological line set out by Deng Xiaoping. “To depart from the actual contemporary development of China in order to discuss Marxism is meaningless,” asserted Jiang (Ling and Ma 2011). In a speech made at the fifteenth Party congress in September 1997, Jiang delved into the issue of ownership:

[T]he leading function of the public economy is reflected in its capacity for control . . . If public ownership continues to be the main system of property relations and the state controls the national economic lifelines, and the capacity for control and competitiveness of the state-owned economy are strengthened, under these conditions, a marginal reduction of the overall proportion of the public sector [understood to include both state-owned and collective enterprise] will not influence the essence of China’s socialism.

JIANG 1997

Jiang’s perspective on the issue of ownership reform was lauded by the media—though notably not officially endorsed—as a “third liberation of thought” (*Jingji Shibao* 1997). In this manner, Jiang sought to situate his statements in the same realm as the anti-conservative ideology of his predeces-

188 “Guanyu shenhua daxing qiye jituan shidian gongzuo yijian de tongzhi” (1997).

sor Deng Xiaoping.<sup>189</sup> Indeed, the policy of grasping the large and releasing the small was widely regarded by both domestic and foreign observers as a momentous advance in China's economic reforms. Within a single year, the number of SOEs was reduced by over a third (NBS 2005, table 5). The state's decision to concentrate public ownership within pillar industries was bolstered by the influence of the Asian financial crisis. Although China had been comparatively insulated from the economic recession that swept across the Asian economies, the problems experienced by Korea's debt-laden and diversified conglomerates convinced the leadership that SOE should retract from light industry (Wang 2011).

However, the strategy was more instrumental in consolidating central control over the public economy while relieving itself of the burden of loss-making enterprise than addressing the systemic inefficiencies which had cropped up in previous decades.

Tellingly, Zhu Rongji, who had been instrumental in the articulation of reforms during the fourteenth congress, fervently opposed the direction of economic policy. In September 1998, the *People's Daily* published a poignant appeal by Zhu to stem the tide of privatization. Said Zhu:

There are some that believe that privatization can bring about prosperity, that privatization is inevitable, and that privatization reflects reform and opening. Such naiveties are utter nonsense and complete falsehoods. Privatization is nothing less than a crime, causing the enrichment of a tiny minority of people while harming the interests of the majority. Privatization will only damage reforms and opening up, will cause economic disorder, and will most definitely not invigorate the economy (*Renmin Ribao* 1997).

In an internal report to the Chinese Federation of Trade Union, Zhu was yet more explicit in his condemnations: "Presently there has appeared a kind of misleading thought, and the sale of enterprise has already become customary, and this is euphemistically called grasping the large and releasing the small."<sup>190</sup>

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189 Recall that the first and second liberalizations of thought were initiated by Deng in 1979 and 1992 to overcome Hua Guofeng's "two whatevers" and the conservative discourse of "capitalist or socialist genealogy."

190 Zhu (1998). The federation is in fact a part of the Chinese industrial bureaucracy.

*Stabilization, the Advance of the Non-State Economy and the Stagnation of Reform*

Zhu's vehement objections were of no avail. In the following years, the state forged ahead with the divestment of the majority of public enterprises.<sup>191</sup> In the following years, the number of SOEs rapidly decreased, and some 30 million workers were laid off.

By the end of the 1990s, central fiscal and monetary influence had been effectively established, and inflation had been brought under control. While, as Zhu had anticipated, the extensive and largely uncoordinated development of a multifarious ownership system (*duozhong suoyouzhi*) was indeed accompanied by considerable managerial expropriation (Ding 2000; Sun 2002), privatization did result in the hardening of budget constraints. This in turn disciplined investment behavior and alleviated the development of overcapacity in light industry. Macroeconomic stabilization was accompanied by major changes in economic structure. Due to the retrenchment of SOE, the non-state (i.e. market economy) quickly came to account for the larger share of industrial output (see Figure 9). The private sector's standing was greatly elevated first when the Party raised its status from a "supplementary" to an "important" component of the Chinese economy (Jiang 1997), and subsequently when Jiang's ideological innovation of the "three represents" (*san ge daibiao*) legitimized the role of private entrepreneurs within the socialist market economy.<sup>192</sup> In tandem, the economy continued to open up. China's accession to the World Trade Organization (WTO) in December 2001, following a

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191 This view of Zhu Rongji as centralizing planner is different from his characterization by some observers and scholars of a market reformer struggling against vested interests (Brahm 2002; Wong 2016). Eaton questions this view of Zhu and is more in line with Lam (1999) in regarding Zhu as a "neo-conservative" who agreed with Li Peng that strengthening the state economy was of paramount importance and saw SOE restructuring as a means to that end.

192 Jiang's three represents, first articulated in 1999, provided not only the legitimacy for private entrepreneurship, but also the impetus for the inclusion of the entrepreneurial class (Lewis and Xue 2003). In 2002, an amendment to the CCP's Constitution lifted the moratorium for entrepreneurs on CCP admission. Article 1 of the first chapter of the Constitution stated that: "Chinese laborers, peasants, soldiers, intellectuals and advanced constituents belonging to other social classes, who acknowledge the leadership and constitution of the Party and who want to join a Party organization and actively contribute to it, implement the Party's resolve and pay their contributions in a timely fashion can apply for membership of the CCP." In a speech made at the sixteenth Party congress the previous year, Jiang had included entrepreneurs amongst the advanced constituents as "builders of a socialist society."

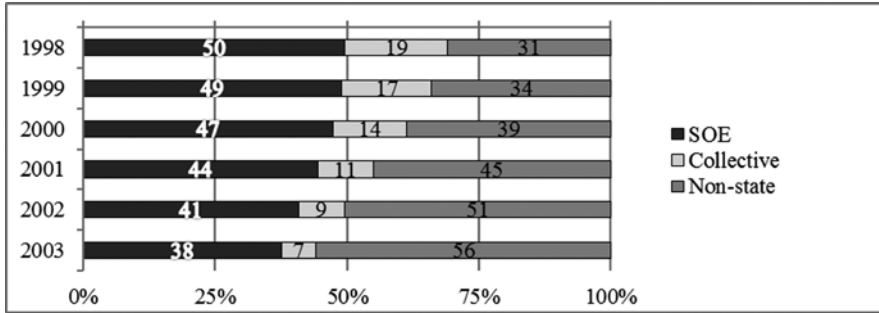


FIGURE 9 *Share of gross value of industrial value by ownership, 1998–2003.*  
SOURCE: NBS (2005, TABLE 41).

decade of negotiations, was a momentous occasion. These changes did much to convince China's liberal economists that the socialist market economy was indeed converging on a system governed by market forces and free from undue government interference (Wang 2011).

Due to the progressive expansion of the private sector, calls for further systemic public sector reforms of the kind initially advocated by Zhu also abated. Several large public enterprises were corporatized—but not privatized—in order to diminish ministerial interference in their operation and promote the consolidation of productive capacity. However, the business groups that emerged as a result of this process were owned and directly supervised by the central state (Brødsgaard 2012). By 2002, only about 30 percent of SOEs had undergone corporatization (Zhang 2004, p. 2043).

In tandem with the divestment of small SOEs, the state rapidly pushed ahead with the reorganization of the capital structure of large enterprise. By the end of 2002, a total of 587 enterprises had undergone debt–equity swaps, involving assets worth 334.48 billion RMB (Research Institute of Finance and Banking of the People's Bank of China 2003). The furious pace at which such restructuring unfolded suggested that the primary concern was with reducing the strain of non-performing loans rather than improving enterprise governance (Heilmann 2008). The economic prowess of the public economy was further bolstered by the changes within the financial sector. Consolidation over banking allowed the government to exert stringent control over interest rates. With personal incomes growing as a result of the upturn in market activity, private deposits had rapidly developed to account for the major portion of credit controlled by China's financial institutes in the initial stages of reform. Widespread corporate restructuring and the laying off of workers in the mid- and late 1990s, in combination with only a slow introduction of a new social

welfare system, caused greater uncertainty regarding incomes and prompted households to save larger portions of their income (Chamon, Liu and Prasad 2010; Ma and Yi 2010; Laffargue and Eden 2015).<sup>193</sup>

High levels of savings made it possible for the mechanism of financial repression to unfold (Lardy 2012; Pettis 2013). The Chinese government consistently held the interest rates of deposits low, in fact at times lower than the rate of inflation. This made it possible to provide loans to SOEs at low interest rates, thereby in fact subsidizing the SOEs. In 2004 the government lowered interest rates for deposits, resulting in average real deposit rates in negative territory (Lardy 2012, p. 84; Kroeber 2016, p. 132). This allowed the banking sector to lend out funds at low interest rates, stimulating a surge in investment. In short, the basic mechanism for pursuing state-led accumulation had changed. Where the accumulation strategy of the 1950s was based on a classic price scissor, the method for securing financial resources for the state sector now was via financial repression.

Cheap bank credit was supplemented by capital raised on China's burgeoning stock markets. The large public business groups that had been formed in the 1990s had been eager to list their most profitable assets on the stock exchange, generating huge capital gains. Some ten years after their establishment, total capitalization had reached 4.1 trillion yuan (Li and Ma 2004). The vast majority of traded shares were issued by state-owned or controlled enterprises. These adjustments to the financial system were accompanied by the reorganization of industry. Within China's pillar industries, emphasis was on the establishment of a situation of orderly competition (*youxu jingzheng*).<sup>194</sup> In this process they were supported by the Chinese state through various preferential policies as well as protective measures against competition from global multinationals. Far from implying an approximation of free market production, the primary objective of instilling orderly competition was to put a halt to pervasive duplicate investments and price competition. Accordingly, the center engaged in a process of reorganization whereby industries—through a series of mergers—were restructured into functional or geographic monopolies (Yeh and Lewis 2004; Pearson 2007). In tandem, the financial performance of the remaining state-owned industry improved remarkably (see Table 8).

193 An important part of the Chinese “savings puzzle” is that corporate savings also increased. This appears primarily to be related to the new tax reform implemented in 1994, which stipulated that SOEs were not required to pay dividend to their owners, the state. This made sense when many companies were struggling to keep afloat. However, as SOEs increasingly turned profitable they amassed considerable saving funds.

194 “Guomin jingji he shehui fazhan ‘jiu wu’ jihua he 2010 nian yuanjing mubiao gangyao” (1996, ch. 3).

TABLE 8 *Indicators of SOE*

	Number of SOEs (1000)*	Workers (mln.)	Output (bln.)	Profits (bln.)
1996	113.8	109.5	2,728.9	41.3
1997	98.6	107.7	2,785.9	42.8
1998	64.7	88.1	3,362.1	52.5
1999	50.7	83.4	3,557.1	99.8
2000	53.5	78.8	4,055.4	240.8

\* From 1996 onward, "SOEs" include both state-owned and state-controlled enterprises.

SOURCE: NBS (2005, TABLE 5).

Developments in the Chinese economy and its related discourse at the turn of the 21st century thus exhibited a peculiar contradiction. The transfer of power to the new generation of leadership appeared to usher in an unprecedented period of liberalization. Deng's southern inspection and the third liberation of thought initiated by Jiang in 1997 had effectively spelled the end of the conservative paradigm. The removal of conservative resistance to reforms was followed by a watershed within public industry and the concomitant upsurge of the private economy. Nevertheless, the reorganization of the public sector and attending changes in the spheres of finance and labor in effect constituted a neo-authoritarian paradigm, devoid of socialist ideological connotations but strongly focused on the preservation and expansion of central control. The introduction of this paradigm was accompanied by a shift in economic logic from the delineation of ownership and property rights within the public sector to one centered on the attainment of scale economies in a relatively small number of centrally controlled enterprises operating in strategic upstream industry. Subsequently, political discussions on the development of a modern enterprise system faded into the background. No wonder then that the initiative of public sector reorganization had been enthusiastically supported by Li Peng, but was decried by leaders such as Zhu Rongji who had advocated more holistic reforms.

The neo-authoritarian paradigm had a marked influence on academic discourse too. As mentioned previously, many economists who had advocated substantial enterprise reorganization and institutional changes endorsed the new course set out by central leadership, considering the policy of releasing the small as a major victory for the process of reform and opening up. Nor did they necessarily dispute the emphasis on scale economies within public

industry; within the context of China's integration in global markets the creation of large, internationally competitive enterprises was widely regarded as necessary (Wu et al. 1997). As a consequence, the third liberation of thought and attendant economic changes prompted a homogenization of discourse. While debate in the first phase of reform (and indeed in the Maoist era) had revolved around competing economic paradigms, involving divergent socio-economic objectives and mechanisms of organizing production and exchange, academic discourse in the late 1990s was predominantly confined to the technical problem of delineation of the public and private spheres of the economy in the most optimal manner.

### **Economic Developments within the Socialist Market Economy (1992–2003)**

Between 1978 and 1992, China's economy had grown at an average 9.3 percent, and per capita gross national product (GNP) had risen from 379 to 4754 RMB (NBS 1996; 2010). However, fiscal decentralization prompted endemic overinvestment, contributing to mounting inflation. The ability of the center to deal with these issues through monetary and fiscal policy had weakened due to its diminished share of revenues. Standardization and unification of the fiscal system, centralization of banking and disbandment of small provincial SOEs curbed reckless industrial investment, restored price stability and increased the financial prowess of the center. Within the period between 1995 (the year following the introduction of tax and banking reforms) and 2000, prices decreased by an average 3.4 percent year on year, lowering the retail price index from 114.8 to 98.5 (NBS 2004). Simultaneously, economic growth, driven by the rapid expansion of the private sector and the upturn of exports and foreign investment continued unimpeded, reaching an average of 9.7 percent (NBS 2010). After some 15 years wherein decentralization and rapid growth had alternated with a reversion to economic planning and stagnation, concurrent economic growth and macroeconomic stability—a major objective of economic leadership—had finally been realized.

The abandonment of principles of central planning and the contract responsibility system in favor of standardized and unified fiscal, monetary and industrial regulation of an increasingly privately operated economy had been pivotal to this achievement. However, to infer that China's economic system was converging on something resembling the Western liberal archetype would be a mistake. Although public industries' share of overall production was decreasing, the volume of assets under purview of remaining SOEs—particularly

TABLE 9 *Indicators of concentration within SOE, 1998–2003*

State-owned/controlled as % of total industry					
	Enterprises	Employees	Assets	GVIO*	Industrial profits
1998	39.22	60.49	68.84	49.63	36.01
2003	17.47	37.62	55.99	37.54	46.01
State-owned/controlled average (monetary values in million yuan)					
		Employees	Assets	GVIO	Industrial profits
1998		579	115.72	51.93	0.81
2003		631	275.73	155.80	11.19

\* GVIO = gross value of industrial output.

SOURCE: NBS (2004, TABLES 14-2, 14-9).

those in strategic upstream industry controlled by central government—rapidly increased. In the same period, the size of private enterprise grew at a much more moderate rate. Thus, the public and private economy developed in contrasting manner, with rapid but diffuse growth (i.e. growth through establishment of new enterprises) prevailing in the private economy and more moderate expansion coinciding with increasing centralization of capital within the (centrally controlled) public sector.<sup>195</sup> Since these enterprises were the main recipients of credit and equity capital and in many instances enjoyed monopoly rents in major upstream industries, their decreasing share of gross industrial output was a poor reflection of their actual significance within the economic system (see Table 9).

Although the reforms of the latter half of the 1990s had invigorated the overall economy and strengthened the fiscal capacity of the central state and public industry, they had done little to curb the reliance of economic development on incessant investment in fixed capital. Vehement competition in labor

195 Aglietta (2000) distinguishes between “consolidation,” which is an expansion of ownership (of a particular agent) over the process of production and “centralization,” which is an increase in assets controlled by a particular actor over and beyond increases in production and overall economic growth.



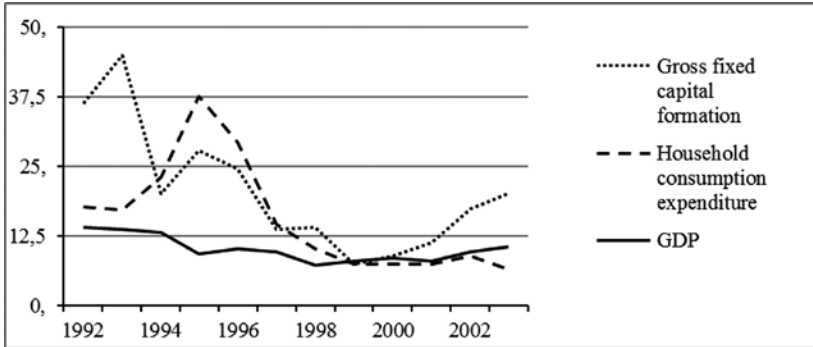


FIGURE 10 GDP and component growth, 1992–2003 (percentage growth).

SOURCE: CALCULATED FROM NBS (2012, TABLES 2-17, 2-18).

markets exerted downward pressure on wages and stymied household consumption. Notwithstanding negative real interest rates, private savings increased in the face of high uncertainty within the labor market, providing cheap credit for further industrial expansion. In an ironic reiteration of the past, private enterprise and households—through the purchase of state-controlled inputs, savings and investment in equity—had come to substitute the agricultural sector as the major source of capital used for the expansion of public industry. From the turn of the century onward, economic growth once more came to rely progressively on investment in fixed assets (see Figure 10). In other words, the fears expressed by Marxist ideologues in their 10,000 character statements were well founded, and the expansion of capital was accompanied by a comparative marginalization of labor interests.

More pressingly still, little had been done to address the disparity between cities and countryside. Although price reforms in agriculture had improved rural living standards in the first stage of reforms, in the 1990s the government had tightened price controls once again in response to the inflationary crisis of 1994 (Chang and Hou 1997). Moreover, the dependence of economic growth on fixed capital caused investments to flow to industry, leading to the neglect of agricultural development (Li et al. 2007). Industrial expansion also drove up the costs of scarce arable land. Finally, whereas the devolution of property rights had made some progress within the industrial sector, there had been none whatsoever within agriculture. Although farmers had been given the right to long-term use of plots, land continued to be the collective property of village administrations. This became particularly problematic after 1994, when local administration began the large-scale transfer of farmland to industry and the property sector, in order to supplement reduced budgetary

incomes (Peck and Zhang 2013). Although farmers lacked property and ownership rights—which created considerable uncertainty and limited incentives for individual investment—the household registration system nevertheless tied them to their plots. Furthermore, although prospects of greater opportunities motivated massive unsanctioned rural migration to the cities, this “floating population” (*luidong renkou*) of rural workers was categorically denied access to public welfare provisions and had no recourse to legal protection. As a result of these developments, income disparity rapidly increased. Between 1992 and 2003 the ratio between rural and urban incomes dropped from 0.39 to 0.31 (NBS 2012, table 10-2), and by 2003, China’s Gini coefficient reached 0.44.<sup>196</sup>

### Conclusion

Accounts of the post-Maoist economic development have tended to emphasize the first phase of reforms. According to this perspective, policies introduced under the third generation of leadership constituted a continuation of liberal initiatives that commenced under Deng (Lau 1999; Wang 2011).<sup>197</sup> Nevertheless, by the time of the fifteenth Party congress, Chinese leadership had formulated and implemented a novel policy paradigm that bore little resemblance to the visions of either the traditional conservative or progressive factions. Indeed, not only did this new paradigm spell the obsolescence of socialist objectives, it also caused the program of enterprise reform to stagnate. From the mid-1990s onward, the traditional covenant between the state and workers steadily eroded. The Labor Law of 1994 and the disbandment of small SOEs caused a definitive break with the iron rice-bowl system, which had furnished workers within the public economy with extensive welfare benefits and lifetime employment. In its stead, a social security system developed that provided workers with the minimal requirements for subsistence while devolving a large portion of welfare expenses to private markets. Neither did the new paradigm amount to an approximation of Western economic

196 See <<http://www.worldbank.org>>; Huang (2008) argues that the 1990s represent “a great reversal.” During the 1980s the rural economy was allowed to take off, led by TVEs. During the 1990s Chinese leaders reversed policies and again began to focus on state-controlled economic policies. Huang calls this policy the “Shanghai model,” as Shanghai took the lead in this particular state-led development focusing on urban regions. Thus, Huang disagrees with the view put forward by, especially, Barry Naughton (1996): that in the 1990s China not only continued but actually deepened the reforms of the 1980s.

197 For a notable exception to this perspective, see Huang (2008).

liberalism. Although Chinese economic development in years to come would be characterized—and indeed largely driven—by the steady growth of the private economy, this expansion was unaccompanied by the expansion of private property rights or the liberalization of factor markets.

Rather, the reforms introduced under Jiang were instrumental in consolidating the fiscal prowess of the center and its grip on economic development (Huang 2008). Public sector restructuring allowed the state to unburden itself from loss-making enterprise while reorganizing large enterprises into giant business conglomerates occupying privileged positions in upstream industry. The development of banking and equity markets provided new sources of capital for these centrally controlled business groups. Meanwhile, reorganization of the fiscal system replenished central revenues. Given these centripetal tendencies, it is worthwhile to ask why the development of this neo-authoritarian paradigm went largely unnoticed by observers of Chinese economics and policymaking. A review of Chinese economic discourse in the 1990s demonstrates that its central elements—though not its objectives—were consistent with the liberal perspectives. The second liberation of thought (initiated by Deng in 1992), which replaced the guideline of capitalist or socialist genealogy with the principle of the three merits, spelled the end of conservative influence within central politics. This defeat likewise caused Marxian concepts of the relations of production and the law of value and their analysis to be relegated to the periphery. From then on, Western neoliberal theories provided the main input to economic discourse.

The impression of a gradual but patent liberal transition was reinforced by developments under the fourteenth Party congress. While, under Deng, persistent contention between conservatives and progressives had caused reforms to proceed in fragmentary manner, under the guidance of Zhu Rongji, central leadership, for the first time, articulated a comprehensive and coherent conceptualization of the Chinese economic system. The socialist market economy was to be one wherein rights to ownership and property would be separated, and where the state's prerogative to invest and divest in enterprise in accordance with the objectives of efficient economic growth and socioeconomic stability would be matched by the right of management to freely attract labor and autonomously decide on matters of production. This would not only require the corporatization of public enterprise, but also the marketization of the spheres of capital and labor. Yet, despite the comprehensive reorganization of economic governance, the state resolved to let public ownership predominate and the non-state economy was confined to a supplementary role. This last hallmark of the traditional socialist template too was weakened when, following Jiang's advocacy for the establishment of a multifarious ownership

system, the overwhelming majority of small and medium-sized SOEs were privatized.

Nevertheless, liberalist readings ignored how the process of privatization was accompanied by a less overt restructuring of central–local and public–private relationships. In order to deal with the economic overheating that had ensued in the wake of Deng’s southern tour, reform of the fiscal and banking systems and wages took precedence over the reorganization of ownership and property rights. Indeed, these measures were effective in restraining inflation and bolstering the center’s fiscal position. However, before comprehensive reforms of the enterprise system commenced in full, they were superseded by the contesting notion of grasping the large and releasing the small. Within these readjustments, emphasis was on the development of a small number of large conglomerates in pillar industries. Through a series of mergers and takeovers, the state created regional or functional monopolies in key upstream sectors, which greatly enhanced the performance of these large enterprise groups. In addition, the central state utilized its control over capital markets to expand state-owned corporate assets.

Subsequently, no substantial alterations occurred to the neo-authoritarian paradigm that asserted itself in the wake of the fifteenth congress. There are arguably several reasons that contributed to the waning of support for further reforms of the kind discussed from the mid-1980s onward. First, leaders who had been in support of the strategy of public sector restructuring had, from the outset, been more concerned with the development of scale-efficient SOE and the consolidation of central control than the delineation of ownership and property rights. Within academia, the demise of Marxian analysis and preponderance of neoclassical theories had caused debate to gradually shift from discussion of the main objectives of, and predominant relationships of production within, the Chinese economy to the maximization of productive efficiency. As such, economic discourse did not produce any viable alternatives to the prevailing system of the socialist market economy. Perhaps most importantly, there appeared to be no need for further substantial reform. In the preceding period, major shifts in policy—both in the direction of further reform and recentralization—had always occurred in reaction to severe structural economic imbalances or volatility. From the late 1990s onward, the Chinese economy experienced rapid growth while maintaining macroeconomic stability. Only recently have the detrimental effects of delayed reforms become obvious. Chapter 4 will discuss whether the lack of institutionalized ownership and property rights will indeed impel a new bout of fundamental reforms and cause a definitive break with the model of the socialist market economy.

# Scientific Development and Domestic Demand (2003–2011)

## Introduction

In the initial period of reforms, China's economy experienced rapid growth. However, the amalgamation of centralized bureaucratic administration and market regulation induced excessive demands for investment and unproductive use of capital. As a result, the pattern of development was markedly volatile. Periods of rapid growth were persistently accompanied by inflation and were therefore generally succeeded by the reinstatement of central controls on capital. After some 15 years of oscillating between conservative and progressive templates, by the end of the 1990s Chinese leadership appeared to have formulated an alternative mode of economic governance that finally achieved the long-pursued twin objectives of rapid development and macroeconomic stability. The consolidation of central control over credit in the mid-1990s hardened budget constraints for local government and enterprise, and the privatization of small enterprise greatly reduced the strain of insolvent public industry. Even when the financial crisis of 1997 swept across the Asian continent, causing widespread stagnation, the Chinese economy remained relatively unscathed, and under Jiang and Zhu, the economy continued to grow at a rapid rate.<sup>198</sup> The economic fortitude of the central state grew in tandem with overall economic development. The 1994 tax reforms had led to a rapid increase of central revenues, and the reorganization of state-owned industrial assets in large conglomerates consolidated central control over China's major upstream industries.

Notwithstanding these economic achievements, pressure for additional reforms mounted. In its pursuit of rapid economic growth, the state had neglected distributive issues. High returns had caused government funds and foreign investment to flow to the modern coastal economy of the eastern provinces. This investment bias stymied development of China's interior, which

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198 Amongst the factors contributing to China's insulation from the Asian financial crisis were the constraints on cross-border capital and currency transactions, curbing the outflow of domestic capital, the predominance of FDI over short-term foreign-invested capital, and the reduction of the scale of non-performing loans (Wang 1999; Yu 2007).

had remained strongly dependent on agriculture and outdated industry. The marked divergence in regional development was accompanied by a widening gap between cities and countryside. Whereas the rural economy had been invigorated by the introduction of TVEs, much of this progress was undone by the reforms of the mid-1990s. The redistribution of fiscal revenues had disproportionately shifted burdens to subnational levels of government. Attempts by local government to compensate for the loss of revenue caused extrabudgetary levies on peasants to proliferate. Moreover, due to the local privatization drive that emerged in the wake of fiscal reforms, a large portion of TVEs had been disbanded. The destabilizing consequences of growing inequality became a prominent subject of debate under of President Hu Jintao and Prime Minister Wen Jiabao. Subsequently, central leadership would emphasize that development needed to promote both growth and social stability (*shehui hexie*, Hu 2007). The shift in central economic discourse from single-minded pursuit of rapid growth to more equitable development was accompanied with significant apprehension about the long-term implications of capital-dependent development. Jointly, societal and strategic concerns caused a widespread perception that a fundamental transformation of the mode of economic development (*jingji fazhan fangshi zhuanbian*) was required, prompting Hu to formulate his “scientific development concept” (*kexue fazhan guan*).

However, in the first decade of the 21st century, the rate of accumulation increased and progress in dealing with issues of rural underdevelopment and interregional disparity was slow. The failure of scientific development to realize a fundamental readjustment in the dynamics of growth was due to the manner in which attempts to deal with sustainability and inequality were framed within the context of the more immediate problem of stimulating domestic demand. While the departure from economic policy biased toward urban, heavy industry, in favor of a focus on rural development and the promotion of technology-intensive sectors, did expand consumption, its major effect was to intensify accumulation by providing new conduits for investment. In spite of the emphasis of economic discourse on readjustment and sustainability, economic development remained strongly dependent on the continuous expansion of fixed capital.

### Distributive Concerns and the Dynamics of Growth

The scientific development concept, promulgated by Hu Jintao in May 2004 seemed to indicate another turning point in China’s economic development. After some three decades of rapid growth the inherent limitations of

capital-intensive development had become increasingly salient. Labor had remained largely of the unskilled variety. The backward state of China's inland regions provided a stark contrast with the rapid modernization of the coastal areas. Urban–rural imbalances continued to exacerbate and were compounded by social aggravations resultant from the abolishment of the employment guarantee and retrenchment of the public sector. These developments had convinced several scholars and policymakers in the mid-1990s (such as Hong Yinxing of Nanking University, economist and NPC member Song Zexing, and Zhou Zhenhua of the Shanghai Academy of Sciences) that China needed to depart from its established pattern of extensive (*cufangxing*) accumulation.<sup>199</sup> However, the dominant perspective among central leadership in the mid-1990s was that the brunt of adverse effects of economic development could be addressed through the elimination of inefficient industrial capacity.<sup>200</sup>

The scientific development concept represented the attempt by Jiang's successor, Hu Jintao, to comprehensively conceptualize the relationship between the long-standing issues of development, socioeconomic equality and long-term sustainability. However, notwithstanding Hu's efforts to tout scientific development as a seminal extension of the Party's economic discourse, it offered little in the way of truly novel approaches to the problems of worsening inequality and overreliance on the accumulation of fixed capital. As we will discuss below, many of the core elements of Hu's new policy paradigm were actually developed during the tenure of Jiang and Zhu.

### *Readjustment Revisited: Western Development, Urbanization and the Revitalization of Agriculture*

Although the rapid expansion of the rural economy in the initial period of reforms had caused rural and urban income levels to converge somewhat, these advances toward greater socioeconomic equality were reversed by the subsequent reemphasis of industrial development. From the 1980s onward, distributive concerns took a backseat to the objective of economic growth. The initial widening of income differentials was regarded as a natural attendant phenomenon of such growth. Nor was this believed to necessarily impel social instability; while certain people would “get rich first” (*xianfu*) by capitalizing on their novel economic freedoms, the expansion of market relations would eventually ensure equality of opportunity for all Chinese citizens. Up until the latter half

199 Hong (1997); Song (1996); Zhou (1996). Also see “Guomin jingji he shehui fazhan jiu wu jihua he 2010 nian yuanjing mubiao gangyao” (1996, ch. 2).

200 “Guomin jingji he shehui fazhan jiu wu jihua he 2010 nian yuanjing mubiao gangyao” (1996).

of the 1990s, the prevailing opinion among central leadership was that “[destabilizing income disparity] was not directly brought about by government policy, but rather the outcome of a small minority who was contravening the law by exploiting regulatory loopholes” (Jiang 1989). Accordingly, the main social imperative of government consisted of the eradication of arbitrary regulatory distortions of the relationship between productivity and income.

This *laissez-faire* approach to the distribution changed from the mid-1990s onward. Both within academic and policy debate, a majority came to believe increasing inequalities caused serious socioeconomic polarization (*liangji fen-hua*). In an address to the Leading Group for Finance and Economics (*zhong-yang caijing lingdao xiaozu*) in August 1996, President Jiang opined:

The experience of certain developing nations has proven that an excessively unequal distribution of individual and regional distribution of income will prompt contradictions within society, amongst regions and classes, between the centre and locality, and cause great disorder. Therefore, the problem of increasing income and inter-regional inequality must attract our greatest attention. We must persist in the policy of allowing the initial enrichment of a portion of people and areas, so that they can bring about and aid the enrichment of those who are not yet affluent, so as to gradually realize mutual welfare. At the same time, we must turn the adjustment of individual incomes, and reduction of regional economic divergences into a major task relating to our overall situation, so as to grasp and sincerely address the various social relations and contradictions within economic development.

1996

Jiang’s statement amounted to an implicit recognition that the objective of realizing ubiquitous welfare could not be realized by means of a “trickle-down” effect only, and additional state intervention was necessary to maintain social stability.<sup>201</sup>

Among the various explanations proffered for increasing inequalities, the perspective that came to predominate policymaking focused on the economy’s

201 This trickle-down effect theoretically ought to ensure that, while rapid accumulation will initially concentrate capital within the hands of a small cohort of economic actors, improvements in productivity will eventually impel a higher standard of living among the general population. In an argument applicable to the Chinese context, Aghion and Bolton (1997) posit that, particularly in the case of constrained capital markets, additional redistribution is necessary to promote a comprehensive rise in welfare.



dualistic structure (*er yuan jingji jiegou*).<sup>202</sup> Despite the agricultural reforms of the late 1970s, a marked difference in incomes continued to exist between agriculture and more productive industry. Moreover, the spatial distribution of agricultural and industrial activity largely coincided with the regional division between inland and coast and the interregional separation of countryside and city. As such, inequalities were largely circumscribed by the geographic delineation between China's interior and eastern provinces and rural and urban areas (Zhao 1992; Zhao and Li 1992). According to Gu Shutang of Nankai University, this spatial–structural economic juxtaposition was ultimately attributable to insufficient population density, precluding the formation of supply-and-demand-side economies of scale (Gu and Tang 1994). Gu's "consolidation thesis" agreed with extant priorities of central leadership. Notably, by emphasizing how inequality posed a bottleneck to further economic growth, an ostensible tradeoff between efficiency and equity could be avoided. Likewise, the center would be able to leverage its consolidated fiscal position to guide the development of industrial hubs within sparsely populated areas, precluding the need for further systemic reform.

Central initiatives to address regional economic inequalities took the form of the Western Development Program (*xibu da kaifa*).<sup>203</sup> Having pondered the issue over the course of several years, Jiang proposed the program to central leadership in March 1999. In accordance with contemporary economic debate, the development of the interior regions was not only presented as a pivotal measure in the alleviation of income disparity, but also as a requirement for enduring economic growth. The construction of industrial and civil infrastructure would promote both scale economies in industry and the expansion of underdeveloped consumer markets (Jiang 1999). The following month, ministerial and provincial leadership proceeded to discuss the initiative under the guidance of the State Planning Commission. Unsurprisingly, representatives from the western provinces strongly endorsed the strategy. Yet, others believed the central state lacked both the financial resources and the administrative control necessary to successfully engage in western development. Rather, they advocated a continuing emphasis on investment in the coastal regions (Ceng 2010). Ultimately, Jiang's perspective would prevail. In the wake of the Asian financial crisis of 1997, Zhu Rongji had actively sought to reduce China's dependency on foreign markets, and the development of domestic demand

202 See for example Jiang (2001).

203 The Western Development Program targets the provinces of Gansu, Guizhou, Qinghai, Shaanxi, Sichuan and Yunnan, the autonomous regions of Guangxi, Inner Mongolia, Ningxia, Tibet and Xinjiang, and the municipality of Chongqing. See Holbig (2004).

had become a focal point of economic policy (Zhu 1999). This resolve dovetailed with Jiang's drive to exploit the potential market of the interior regions, and the "Decision on Certain Major Issues in the Reform and Development of State-Owned Enterprise" of September 22, 1999, institutionalized central commitment to western development. By 2002, the program encompassed 20 investment projects (mostly related to infrastructure), jointly accounting for over 400 billion yuan (Wallace 2014).<sup>204</sup>

Efforts to deal with the unequal development of city and countryside proceeded in tandem. During the early stages of reform, government had adopted a policy of "controlling the scale of large cities, rationally developing middle-sized cities, and actively developing small cities and villages" (*kongzhi da chengshi guimo, heli fazhan zhongdeng chengshi, jiji fazhan xiao chengzhen*). However, central engagement in developing small cities was, by and large, limited to administrative measures,<sup>205</sup> introduced in order to curb widespread rural migration.<sup>206</sup> Control of population movement, notably by way of the household registration system, which tied access to social welfare to residence status, had been considered pivotal to the maintenance of social stability in China's large cities (Wallace 2014). Although the strategy of rural–urban segregation and development of townships had reduced the development of inequalities in China's coastal metropolises by preventing an influx of poor rural migrants, it had likewise prevented the formation of new urban concentrations. The long-term trend toward socioeconomic polarization and the stymied development of domestic demand bolstered Jiang's resolve to expedite urbanization. The construction and expansion of small and medium-sized cities in China's rural areas would provide an outlet for surplus agricultural labor, and promote industrialization.<sup>207</sup> Trials commenced in April 1995, and in 1998 the strategy of developing urban hubs within the Chinese countryside was elevated to national policy.<sup>208</sup> As a result, the rate of urbanization in the late 1990s rapidly increased; from 1996 to 2003 the proportion of urban citizens

204 Note, however, that a considerable amount of investment had already commenced prior to the initiation of the program, and was subsequently relabeled as part of western development.

205 In October 1984, the "Circular on the Issue of Farmers' Settlement in Towns" allowed rural citizens enjoying steady employment in TVEs or other industrial enterprise and having fixed residency within towns to convert their rural household registration to a township (*chengzhen*) residence permit.

206 Note that the sudden increase in townships from 1983 to 1984 observable in government statistics is chiefly due to statistical reclassification.

207 "Zhongguo xiao chengzhen zonghe gaige shidian zhidao yijian" (1995).

208 "Guanyu nongye he nongcun gongzuo ruogan zhongda wenti de jue ding" (1998).

in the total population rose from 30.5 to 40.9 percent, an increase almost equal to that realized in the entire preceding period of reforms (NBS 2013, table 3-1).

While urbanization sought to reduce socioeconomic divergence through the adjustment of the sectoral composition of China's rural economy, other policies focused on the reorganization of agriculture itself. The first of these measures sought to promote the efficiency of agricultural production through industrialization (*chanyehua*). Within the context of agriculture, industrialization referred to the development of vertically integrated production networks, constituted by an agglomeration of individual producers and controlled by "dragon head enterprises" (*longtou qiye*, see Yan and Chen 2013). In essence, the policy reiterated the logic of the conglomerate strategy within the public sector, whereby the integration of small producers within vast conglomerates would yield economies of scale and promote specialization on the basis of the different comparative advantages of agricultural regions (*Renmin Ribao* 1995). After several years of experiments at the municipal level, agricultural industrialization was elevated to national policy in 1998.<sup>209</sup>

In addition to attempts to increase agricultural productivity, the state introduced fiscal policies which sought to directly increase peasant incomes. Trials with so-called "from fee to tax" (*feigaishui*) reforms commenced in March 2000. Under these reforms, the tax rate on agricultural produce was decreased to 7 percent (calculated on basis of an estimate of 1998 yields), and the various extrabudgetary levies on peasants which had financed public services at the village level were abandoned in favor of a standardized surcharge on agricultural tax. Finally, the practice of compulsory labor for the construction of village infrastructure was abolished.<sup>210</sup> These reforms, however, proved ineffective in improving peasants' livelihood. Implementation of the new tax scheme was heavily contested by poorer localities, which saw their fiscal base erode as a result of the abolition of extrabudgetary revenues. In a reiteration of the dynamics following the tax reforms of 1994, local administrations increasingly turned to the expropriation of farmland in order to compensate for the loss of income (Day 2013). Ironically, the exploitation of farmers was exacerbated by the urbanization drive, which drove up demand for land (Sargeson 2013). Between 2000 and 2003, real rural consumption expenditure rose by a mere average 3.7 percent (by contrast, urban consumption expenditure in the same period increased by an average 6.1, NBS 2012, table 2-24).

209 Li (1998, ch. 2).

210 "Guanyu jinxing nongcun shuifei gaige shidian gongzuo de tongzhi" (2000).

*From Extensive to Intensive Development: Nurturing the Indigenous Capacity for Innovation*

Introspection about the structural characteristics of China's economic development and its distributive implications was accompanied by a debate on the limitations of its dynamics.<sup>211</sup> From the latter half of the 1990s onward, both economists and policymakers fervently discussed the transition from extensive to intensive growth.<sup>212</sup> Extensive accumulation occurs through the continual addition of heretofore unutilized resources and labor (Andreff 1978; Aglietta 2000). By contrast, under intensive (*jìyuèxíng*) accumulation, growth occurs primarily because of innovation, that is, through the continuous reorganization of capital and labor into more productive configurations (Lipietz 1988).<sup>213</sup> Chinese discourse highlighted how both endogenous and exogenous influences mandated an imminent shift toward a predominantly intensive pattern of accumulation. A first such catalyst derived from the dynamic of economic development itself. Due to the predominance of agriculture, backward production technology and a lack of effective domestic demand characteristic for emerging economies, initial development would have to capitalize on the comparatively abundant supply of labor and natural resources. Market expansion would, however, create scope for the development of scale economies, investment in fixed assets and labor specialization. At such a point, the reliance on comparative advantage ought to be decreased in favor of a strategy of developing institutional advantages within specific productive processes (Zhou 1996).

Not only do endogenous dynamics push for the transition toward intensive accumulation, but there are also inherent limits to the continuation of an extensive mode of accumulation. Due to the finiteness of labor and capital and diminishing returns to factor addition, argued Song Zexing, sustainable growth depended ultimately on continual increases in productivity, realized through technological innovation (Song 1996). Within China, the constraints of extensive accumulation were reflected in a high rate of capital formation and

<sup>211</sup> That is, sectoral and spatial.

<sup>212</sup> Although such discussions had commenced in the early 1980s, in his closing address to the fifth plenum of the fourteenth Party congress, Jiang stated that “[We] must revise our conceptualization of development, and realize the transition from an extensive to intensive mode of development.” Jiang (1995). See also Li (1995a).

<sup>213</sup> Although the terminology derives from Soviet Marxian analysis, the concepts are also widely applied in neoclassical literature. Consider, for example, the seminal Solow model (Solow 1956), which disaggregates the factors of economic production in labor and capital, and technology (where increases in the first two factors impel extensive growth, and the latter condition causes intensive growth).

correspondingly limited increases in consumption. Extensive accumulation also increased environmental degradation (Jiang 1995).<sup>214</sup> Finally, pressures to realize the transition toward intensive accumulation were compounded by China's integration into the global economy. While, initially, the ample supply of unskilled labor had provided China with a comparative advantage in the production of labor-intensive goods, rising wages caused this advantage to dissipate (Hong 1997).

Differing opinions existed on how to realize such a transition. Noted reformist Wu Jinglian argued that increases in factor productivity depended first and foremost on efficient market allocation of capital and competition between economic actors. As such, the transition toward intensive accumulation would require further liberalization of factor markets and industries (Wu 1995). However, within the context of the ascending neo-authoritarian paradigm, the solution that was adopted by government suggested an expansion, rather than contraction, of the remit of regulation. The conceptual foundation for the state's attempts to alter the dynamics of production was provided by the literature on national innovation systems (*guojia chuangxin tixi*). While the literature on national innovation is conceptually diffuse, the variety (Freeman 1987; Lundvall 1992; Edquist 1997) that proliferated in China took its inspiration from the political economic theory of Friedrich List (Freeman 1995). A late 19th-century political economist, List squarely contradicted the liberal perspectives of his British contemporaries by arguing that government planning plays an indispensable role in the development of national technological competence and international competitiveness. Similarly, the associated brand of innovation systems thinking insisted that government coordination is necessary to nurture innovative competences within industry. Building on the experiences of East Asia's developmental regimes, the national innovation systems literature posited that such coordination ought to ensure the development of close ties between the industrial bureaucracy, education and research institutes and enterprise, which promote the introduction of efficiency- and quality-enhancing technology within industry, and gradually impel a sectoral redistribution within the economy from low to high value-added processes.

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214 By the end of 1991, after three years of conservative economic governance, the ratio of gross fixed capital formation to GDP had been reduced to 27.9. However, in subsequent years, economic growth had once again been sustained by large-scale investment in gross fixed capital, and by 1995, its ratio had increased to 34.4. This increase had been accompanied by a corresponding decrease in household consumption expenditure from 49.3 to 46.7 percent (calculated from NBS 2005, table 10).

The concept of the national innovation system was first introduced to China's leadership by way of a report produced by the Chinese Academy of Sciences in December 1997. It argued that, through the establishment or expansion of central programs that supported the development of leading enterprises, research institutes and universities, China ought to pursue breakthroughs in technologies of particular strategic importance to economic development (Chinese Academy of Sciences 1998). The report was enthusiastically received by Jiang, who himself had called for the "invigoration of the nation through science and education" (*kejiao xing guo*) some years prior (Chen 2002).<sup>215</sup> The commitment of the center to the development of China's innovation system was reflected by the establishment of the National Leading Group for Science, Technology and Education (*guojia keji jiaoyu lingdao xiaozu*) in 1998.<sup>216</sup>

In the following Tenth Five Year Plan, the government presented the outlines of a novel strategy for economic development based on a gradual shift from the expansion of capital in traditional industry to the nurturing of a select number of technology-intensive sectors.<sup>217</sup> Industries such as information and telecommunications, production automation and renewable energy would not only be crucial in increasing overall productivity, but also presented opportunities for the development of a national competitive advantage. Korean and Japanese precedents convinced the government that China could "leapfrog" (*kuayueshi fazhan*) within such technology-intensive industries through absorption of mature technologies (Cao, Suttmeier and Simon 2009).<sup>218</sup> According to the concept of technological leapfrogging, developing nations have singular opportunities to achieve or approximate the technological frontier within selected sectors by skipping certain stages within the development trajectory of these technologies. Specifically, such development is possible when requisite knowledge and technology is readily available within international markets, when innovations succeed one another at a rapid pace (resulting in quick commoditization and low costs), and when technological development is science- rather than experience-based (i.e. radical rather than incremental) and innovation is complementary, rather than labor-substituting (Soete 1985; Lin and Zhang 2005).

Jointly, discourse on issues of social redistribution and the transition from extensive to intensive growth suggested a shift away from the traditional,

215 "Guanyu jiasu kexue jishu jinbu de jueding" (1996).

216 "Guowuyuan guanyu chengli guojia keji jiaoyu lingdao xiaozu de jueding" (1998).

217 "Guomin jingji he shehui fazhan di shi ge wu nian jihua gangyao" (2001, ch. 4).

218 See also chapter 2 of *ibid*.

accumulation-centric economic paradigm. However, driven by rapid urbanization and the incessant expansion of industry,<sup>219</sup> the high rate of formation of fixed capital was sustained throughout the second half of the 1990s.<sup>220</sup> The 11th Five Year Plan,<sup>221</sup> prepared under the direction of Hu and Wen, stated that: “Amidst rapid development during the Tenth FYP period, certain prominent issues appeared: the relationship between investment and consumption was unbalanced, part of industry blindly expanded, production capacity was excessive, transformation of the mode of economic development slowed down, energy resources are strained, environmental pollution has exacerbated, the regional development gap and the income gap between certain groups in society has continued to increase, the development of public services is still lagging behind, and the elements inciting social instability are manifold.”<sup>222</sup>

### The Scientific Development Concept

Hu’s response to the plethora of social and economic problems came in the form of the scientific development concept.<sup>223</sup> According to the concept, a scientific appraisal of the dynamics of economic development and their concomitant imbalances demonstrated an objective need to depart from the extant growth-oriented paradigm to people-oriented, comprehensive, coordinated and sustainable development. The notion of taking people as the basis (*yi ren wei ben*) implied an emphasis on the qualitative as well as quantitative dimensions of economic growth. More egalitarian development would not only alleviate mounting social tension but also facilitate the transition toward a pattern of growth less dependent on the continual expansion of capital and driven

219 In the Tenth Five Year Plan period, the real growth rate of investment in urban construction was an average of 22.1 percent, while industry grew by an average 9.8 percent. By comparison, average GDP growth in that period was 8.4 percent (NBS 2013, tables 2-5, 5-7, 10-1).

220 In 2000, the ratio of gross fixed capital formation was virtually identical to that of 1995 at 34.1 percent.

221 2006–2010.

222 “Guomin jingji he shehui fazhan de shiyi wunian jihua gangyao” (2006).

223 The concept of “harmonious society” was first propagated in the Resolution of the sixteenth Party congress in November 2002, and further elaborated at the fourth plenary session of the sixteenth Central Committee in September 2004. In an important speech by Hu Jintao from February 2005, but only published in July 2005, the Chinese leader argues that harmonious society is the “foundation for the consolidation of the governing capacity of the party and the realization of its leading role” (Hu 2005).

by domestic consumption (Hu 2004). The gradual move from heavy industry toward knowledge and technology-intensive sectors would adjust investments toward labor, resulting in higher wages and lower consumption of natural resources. Comprehensive development (*quanmian fazhan*) sought to ensure an even pace of economic, political, cultural and social reform. Holistic, planned development (*tongchou fazhan*) of the relation between city and countryside, between regions, between economy and society, between people and environment and between the nurturing of domestic demand and further opening up (*wuge tongchou*) would ensure harmonious (*hexie*) growth. Finally, sustainable development (*ke chixu fazhan*) would, first and foremost, depend on the restructuring of the industrial composition of Chinese economy. The traditional emphasis on heavy industry would have to be abandoned in favor of less resource- and capital-intensive industries characterized by a strong reliance on technology and high-skilled labor (*Renmin Ribao* 2006).

Surprisingly, one of the earliest and most resounding endorsements of the scientific development concept originated abroad. According to long-time China observer Joshua Cooper Ramo, the emergent form of governance, which he coined the Beijing consensus, constituted a viable challenge to the liberalist template for economic development (Ramo 2004). The Washington consensus—if not in its original conception then in its subsequent prevalent reading—encapsulated the Western neoliberal model of fiscal discipline, the liberalization of factor markets and international trade and investment, and the predominance of private property (Williamson 1993). This model—or at least the variety adopted by Western international institutions (Babb 2013)—advocated a development strategy unequivocally focused on the promotion of growth through exploitation of comparative advantage within the international economy. The Beijing consensus was rather based on comprehensive socioeconomic development, the nurturing of advanced technological capacities, and strategic economic and political leverage. Such a paradigm, argued Ramo, was both attuned to the need for more egalitarian and sustainable development within the Chinese economic system and the increased volatility of international markets (2004).<sup>224</sup> Following its initial promulgation, the Beijing consensus gained considerable traction among China's academics (notably Hu Angang, director of the Qinghua Center for Research of the National State of China (*Zhongguo guoqing yanjiu zhongxin*)), and ideologically-oriented publications such as *Contemporary World and Socialism* (*Dangdai shijie yu shehui zhuyi*) in particular actively propagated the concept.

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224 See Halper (2010) on the international implications of the Beijing consensus.



However, in spite of the assertions of advocates of the Beijing consensus, the promulgation of the scientific development concept did not portend the emergence of a truly novel economic paradigm. While Hu's contribution to the ever-expanding repertoire of Party ideology seemed to signal that central policy would become less focused on accumulation and egalitarian development had become the overriding priority,<sup>225</sup> both in terms of ideology and concrete policies, scientific development offered little substantive novelty. The notion of comprehensive development recapitulated Jiang's three represents, which had called for the development of the advanced productive forces (*xianjin shengchanli de fazhan*) and advanced culture (*xianjin wenhua*), and the Party's unequivocal pursuit of the interest of the majority of people (*zui guangda renmin de genben liyi*, Jiang 2001).<sup>226</sup> Holistic planned development reiterated 5 of the 12 "major relations" (*zhongda guanxi*) which Jiang had emphasized during the fifth plenum of the fourteenth Party congress.<sup>227</sup> Likewise, the discussion on sustainable development primarily echoed the economic debate on the transition toward intensive accumulation that had commenced in the mid-1990s.

*Developing Domestic Demand, Constructing a New Countryside  
and the Advantage of Large Nations: Theory and Policy under  
Jiang and Hu*

Given its derivative character and ostensibly limited stature in political and economic discourse,<sup>228</sup> it would seem straightforward to conclude that the concept of scientific development concept did not influence economic

225 Officially, this repertoire comprises Marxism–Leninism, Mao Zedong thought (*Mao Zedong sixiang*), Deng Xiaoping theory (*Deng Xiaoping lilun*) and Jiang Zemin's three represents (*san ge daibiao*).

226 The rather arcane formulation of the three represents in fact refers to Jiang's endorsement of China's emerging entrepreneurial constituency (i.e. the advanced productive forces), the development of education and higher education in particular (i.e. advanced culture), and attempts to increase intra-Party democracy and combat corruption (i.e. the interests of the popular majority).

227 Besides the five aforementioned relations, these included the relations between reform, development and stability; the speed and efficiency of growth; the sectors of the economy; market allocation and macroeconomic control; the public and non-public economy; center and localities; and military and economic development; see Jiang (1995).

228 Under Hu's presidency, the concept of scientific development received but little attention in leading economic publications. Similarly, an initiative to include the concept into China's Constitution in 2008—ensuring equivalent status with the ideological contributions of earlier leaders—was eventually abandoned.

development in any material manner. The main consequence of the discourse of scientific development was neither a shift in the stipulated priorities nor instruments of economic governance, but rather to bring about the inherent association of egalitarian and sustainable development with the issue of expanding domestic demand. Discussions on the issue of domestic demand had preceded the formulation of the scientific development concept by several years. The predominant streams of thought advocated a strategy of increasing Chinese consumption and investment through the establishment of new markets.

The first of these streams of thought addressed the inherent limitations of a strategy of economic development focused on heavy industry. While high rates of fixed capital formation within industry had continually exerted a constraining influence on increases in household consumption expenditure (HCE), growth of the latter had been particularly lackluster in the second half of the 1990s. Due to the decline in economic growth brought about by the Asian financial crisis, expansion of domestic demand had become an explicit guideline in national economic policy from 1999 onward. However, in the immediate aftermath of the crisis, state investment targeted the traditional foci of public industry and capital construction.<sup>229</sup> However, the effect of these stimuli was limited. Lack of consumption expenditure was accompanied by a decrease of investment demand as the depletive effects of structural industrial overcapacity were intensified by reduced domestic consumption and dwindling exports. Lin Yifu argued that, given the inefficacy of direct government investment and limited contribution and scope for increasing exports, resultant deflationary pressure was to be diffused by the exploitation of latent rural demand (Lin 1999). HCE in China's rural areas had been constrained by a lack of requisite infrastructure. The construction of electricity, water and road networks in China's rural villages would not only result in an instantaneous upsurge in demand for major household appliances such as washing machines, refrigerators, televisions and automobiles, but also create additional employment opportunities for the rural working population (Lin 2000).

The second stream of thought expounded on the characteristics and advantages of large economies (*da guo jingji*). Emerging in the context of growing apprehensions about the benefits of unmitigated international economic integration, the large economy debate asserted that the state could exploit China's

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229 In 1998, economic stimuli resulted in a 100-billion-yuan increase in public debt. The majority of investments targeted capital construction. In addition, SOEs' investment in fixed assets increased by 19.5 percent (compared to an average national increase of 14.1 percent). See Zhu (1999, ch. 1).

size to expedite development and promote its international competitiveness. Influential economists such as Hu Angang proposed that the establishment of new industries and services and urbanization would promote the expansion of domestic demand, providing new impetus to economic development and decreasing dependence on global markets (Hu 1998; see also Zhang 2001; Chen 2002).<sup>230</sup> Through the agglomeration of newly established industrial capital and concentration of the population in urban hubs, such a strategy would also promote the development of scale economies and labor specialization. At the same time, by leveraging domestic demand and its concomitant supply-side advantages, large nations would have singular potential to compete on international product markets.

*Scientific Development and the Keynesian Guise of the Chinese State*

Although the notions of exploiting the latent demand of the countryside and the nurturing of novel industries would stipulate the course of economic policy in the first decade of the new millennium, their influence was not immediate. As stated previously, initial attempts by the state to reinvigorate the sluggish economy amounted simply to an increase of expenditure within the traditional focal areas of the producer goods industry and industrial infrastructure. Such measures, however, exacerbated the problem of structural overcapacity and thus did little to increase domestic demand.<sup>231</sup> The following years saw the substitution of consumption-oriented measures for the initial investment-centered stimuli. The government's 2002 work report insisted that the expansion of demand "first and foremost required the increase of urban and rural incomes, and that of low income groups in particular, so as to nurture and increase household purchasing power" (Zhu 2002). Wages in public industry were adjusted upward, and state expenditure on social welfare increased.<sup>232</sup> In addition, the government introduced the "from fee to tax" reforms within the rural economy. Although fiscal redistribution did indeed result in an increase of incomes, this did not translate into a commensurate rebalancing of

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230 It was further argued that on the supply side, the exploitation of potential domestic demand would promote the development of scale economies and labor specialization.

231 Boyer (2012) argues that the destabilizing effect of this structural overcapacity has been reduced predominantly by way of export. However, due to the crisis-induced slump of demand within international markets, export contracted, increasing the strain of overcapacity on the Chinese economy.

232 Between 1999 and 2002, state expenditure on social welfare increased from 1.34 percent to 2.19 percent of GDP (NBS 2013, tables 2-1, 9-1).

investment and consumption. Despite tax reforms, urban and rural wages continued to grow at divergent rates,<sup>233</sup> and in the face of higher uncertainty about employment tenure and increased personal expenditure for welfare services, the propensity to defer current consumption persisted (Chamon, Liu and Prasad 2010). On the supply side, increases in consumption continued to be constrained by the concentration of investment in industries already characterized by excess capacity.

As a result of these persistent problems, the notion of restructuring the composition of domestic capital gained increasing traction amongst Chinese leaders. In 2001, Justin Yifu Lin, director of the Research Center for the Chinese Economy at Peking University, wrote a direct appeal to President Jiang, reiterating his position that both the industrial surplus and excessive supply of industrial investment ought to be addressed by reallocating investment to China's countryside (Wen 2010). The topic of "establishing of a new socialist countryside" (*xin shehui zhuyi nongcun jianshe*) was discussed during a dedicated conference held in Beijing the following year (Yan and Chen 2013). The government's work report, issued in 2003, for the first time emphasized how efforts to stimulate domestic demand ought to expedite both the convergence of incomes and industrial restructuring (Zhu 2003). However, it wasn't until the transfer of leadership from Jiang and Zhu to Hu and Wen that these measures were put front and center of economic policy. In 2004, Hu decided to proceed with a progressive reduction of agricultural tax, leading to its complete annulment in 2006 (Hu 2004). In order to prevent further erosion of the fiscal position of local government, these changes were accompanied by an increase of fiscal transfers from the center. In 2005, central leadership determined that central outlays for the development of the countryside should increase on a year-by-year basis.<sup>234</sup> Central outlays for the improvement of rural welfare during the period of the 11th Five Year Plan totaled 2,39 trillion yuan (Wen 2006–2010).<sup>235</sup> From 2003 to 2010, investment in agricultural development

233 In fact, urban residents had enjoyed tax exemptions for the first 9,600 yuan of income, whereas rural incomes had been taxed on the full amount (Wallace 2014).

234 "Guanyu tuijin shehui zhuyi xin nongcun jianshe de ruogan yijian" (2005, ch. 1).

235 Before the beginning of the economic reform period, five-year plans were mandatory and set detailed production targets. During the 1980s and 1990s five-year plans increasingly only served as a framework for policies or as a catalogue of issues that needed to be addressed. The Eleventh Five Year Plan reflected this development by calling the plan "*guihua*" rather than "*jihua*." While both can be rendered plan in English, "*guihua*" has a connotation of a draft or regulatory guidelines subject to possible revision, whereas "*jihua*" often refers to a set of concrete plans.

grew from 4.6 to 9.1 percent of total state expenditure (NBS 2004; 2011, table 8-5).<sup>236</sup> Driven by these fiscal transfers to agriculture, rural incomes rose rapidly after 2006.<sup>237</sup> The increase in rural incomes in turn contributed to the growth of HCE.

Notwithstanding the impetus to consumer demand provided by agricultural transfers, growth under Hu continued to be predominantly (and progressively) driven by investment in fixed assets. Although the concept of a new socialist countryside was broader in substantive scope than preceding programs, urbanization continued to stand firmly at the core of rural development. Urban investment in fixed assets reached an average real growth rate of 26.8 percent in the same period, pushing the urban share of total investment in fixed assets to 86.8 percent (see Figure 11). In tandem, the proportion of urban residents within the overall population rose to 51.3 percent, continuing the urbanization drive commenced under Jiang (NBS 2014, tables 3-1, 5-7, 10-1).

Much like the administration's efforts to address socioeconomic issues, measures to promote the development of innovative capacity and realize the transition toward an intensive pattern of growth were shaped by a preoccupation with the development of domestic demand. For most of the post-Mao era, the state had relied on technological transformation (i.e. the purchase of turn-key installations) and a *quid pro quo* arrangement whereby foreign enterprises'

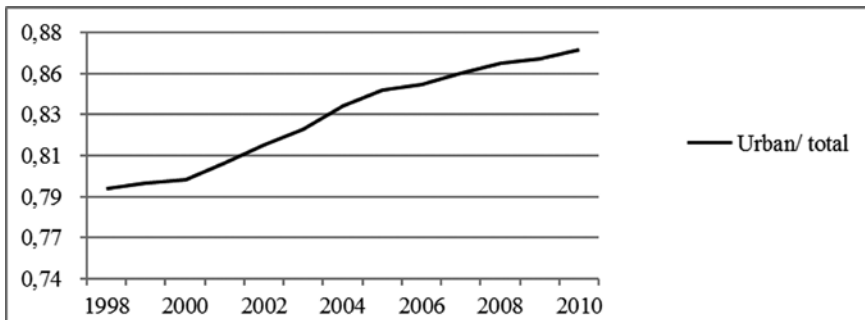


FIGURE 11 *Urban investment in fixed assets as share of total, 1998–2010.*

SOURCE: NBS (2014, TABLE 5-2).

236 Including forestry and irrigation.

237 In the Eleventh Five Year Plan period (2006–2010) the average real growth in rural incomes was 12.32, compared to 7.53 in the preceding Five Year Plan period. See also Figure 12.

access to Chinese markets was made contingent on the supply of advanced production technology. By contrast, the novel strategy, expounded in the “Medium and Long-Term Plan for the Development of Science and Technology,” focused on the expansion of consumption and investment in domestic technology. The plan defined 16 national objectives (*keji zhongda zhuanxiang*).<sup>238</sup> Excluding items within or related to the military sphere, new foci emphasized areas of biological, information and communication, and energy technology, which were believed to provide opportunities for technological leapfrogging. Central investment in these projects totaled 619.7 billion yuan in the 11th Five Year Plan period (Wen 2006–2010). Centrally coordinated initiatives were complemented with local policies. In the wake of the promulgation of the long-term plan, government issued its “Measures on Management of the Approval of Indigenous Innovation Products.” Subsequently, procurement catalogues extending preferential conditions for domestic manufacturers in government procurement tenders were developed at both national and local levels (Lundvall et al. 2009). By way of these procurement policies, the state sought to leverage domestic demand in order to develop scale economies within high-tech industry and promote the creation of de facto international technological standards. The outcomes of this strategy have been equivocal.<sup>239</sup> However, like efforts to establish a new socialist countryside, the initiative to develop China’s high-tech industries has been crucial in redirecting investment from traditional heavy industry and creating new sources of demand.

238 Three of these are classified defense-related projects. The other 13 are: (1) core computer components, high capacity processors and basic software; (2) integrated circuits; (3) wireless broadband communication; (4) numerical controlled machine tools; (5) oil and gas exploitation; (6) large-scale nuclear power plants; (7) water and waste treatment; (8) genetic modification; (9) pharmaceuticals; (10) contagious disease prevention; (11) large aircraft; (12) high resolution earth observation systems; and (13) manned space travel and lunar exploration. Available online at: <<http://www.most.gov.cn/kjgh/kjghzcq/>>.

239 From a commercial perspective, China’s rapidly growing share of the global photovoltaic market is particularly noteworthy. The development of scale economies realized by nurturing domestic demand has been instrumental to the success (Liu and Goldstein 2013). On the other hand, the development of China’s proprietary fourth-generation cellular communication standard, TD-LTE—while technologically impressive—has come at the expense of considerable losses, owing to large-scale infrastructural investment and slow consumer response (Vialle, Song and Zhang 2012).

TABLE 10 *Share of industrial investment in fixed assets by sector, 2003–2010 (%)*

Industry	2003	2006	2010
<i>Communications, computing</i>	9.3	6.4	5.2
<i>General purpose machinery</i>	N/A*	6.0	7.3
<i>Electrical machinery, equipment</i>	N/A	4.2	6.7
<i>Special purpose machinery</i>	N/A	N/A	5.6
<b>High-tech (total)</b>	<b>9.3</b>	<b>16.6</b>	<b>24.8</b>
Chemical materials, products	8.7	8.7	9.2
Non-metallic mineral products	7.0	7.0	10.1
Transport equipment	5.2	7.5	8.8
Non-ferrous metals	5.1	N/A*	N/A
Textile	4.9	4.8	N/A
Medicine	4.4	N/A	N/A
Food processing	4.1	4.5	4.9
Metal products	N/A	N/A	4.9
Other	37.5	41.2	37.3

\* For high tech, these categories did not exist up until the year where their figures are added to the table. For regular industry, categories are left blank when they no longer make up part of the largest investment destinations.

SOURCES: CALCULATED BY AUTHOR FROM NBS (2004, TABLE 6-9; 2007, TABLE 6-13; 2011, 5-14).

### Economic Development under the 11th Five Year Plan (2006–2010)

Although the ostensible focus of the discourse of scientific development was on issues of socioeconomic divergence and long-term economic sustainability and competitiveness, both the discourse on scientific development and concomitant programs geared toward regional and rural development and the nurturing of indigenous innovative capacity were in fact continuations of policies set in motion under Hu's predecessor. Thus, the distinctive quality of economic regulation from 2003 onward resides in the manner it appropriated the principle of readjustment to address the more mundane problem of overaccumulation. In the face of decelerating growth and the limited efficacy of traditional state investment, policy under Hu and Wen focused on developing domestic demand and the diversification of investment. The implications of the changing character of instruments implemented to promote domestic demand can be inferred from aggregate economic development. As shown

in Figure 12, the traditional strategy of increasing investment in industry and urban areas pursued in the latter years of the 1990s failed to realize a significant acceleration of the growth of household consumption expenditure (HCE). Limited increases in the domestic consumption was due predominantly to the slow growth of rural incomes. With the step-wise abolition of agricultural taxes under Hu and Wen, rural incomes did increase rapidly, causing a more even rate of growth in cities and countryside. Household consumption rose in tandem, even surpassing the rate of growth of GDP in 2007. The acceleration of the growth of household consumption was temporarily reversed due to economic recession precipitated by the global financial crisis in 2008. However, in the years following, the general trend toward higher consumption expenditure—driven in large part by 4 trillion yuan in central stimulus—continued.<sup>240</sup>

In spite of the higher growth rate of household consumption, the reliance of the Chinese economy on additions to the stock of fixed capital has increased. The development of new urban hubs, rural infrastructure and technology-intensive industries provided novel outlets for capital, allowing for the continuation of rapid GFCF without creating additional duplicative investment and contributing to the problem of excessive capacity. These forays into heretofore unexploited regions or industries translated into rapid growth. China's GDP increased by an annual average of 10.9 percent between 2003 and 2012

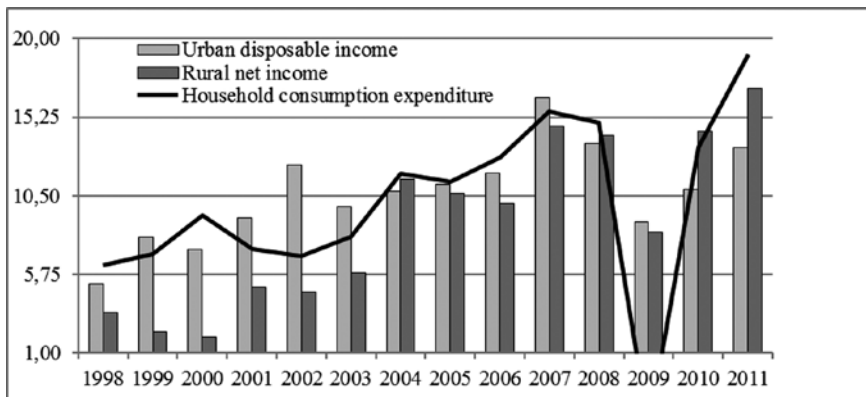


FIGURE 12 *Year-on-year percentage growth of household consumption and incomes under three diverging fiscal policies, 1998–2011.*

SOURCES: NBS (2009, TABLES 1-10, 1-21, 1-23; 2013, TABLES 2-19, 10-1, 11-2).

240 Of this 4 trillion, 43.7 percent was expended on subsidies to household consumption, such as government-subsidized housing, rural health care and education and other public services, while the remainder was invested in the development of indigenous innovation, industrial restructuring and environmental measures (15.3 percent), major infrastructural projects (23.6 percent) and disaster relief 14.8 percent. See Wen (2010, ch. 1).



(NBS 2012). Even as the financial crisis caused global stagnation in 2008 and 2009, Chinese economic growth, bolstered by increased government spending, reached 9.6 and 9.2 percent (see Table 11). In the same period, GFCF as a share of GDP steadily grew, from 38.5 to 44.5 percent, far surpassing the rates achieved during China's Great Leap Forward (Table 12).<sup>241</sup> Even after the turn of the century, when central government seemed resolved to decrease its dependence on investment-driven development in favor of a model stressing socioeconomic development and industrial innovation, the expansion of fixed assets continued to accelerate as this new resolve coincided with an emphasis on sustaining economic development by promoting the agglomeration of supply and demand. Although sectoral adjustment, urbanization and investment in rural infrastructure did fuel rapid economic growth, policies intensified reliance on accumulation, rather than effectuating a transition toward a more balanced trajectory of development.

TABLE 11 *Economic growth rates in China, 2002–2015 (%)*

Year	Growth rate
2002	9.1
2003	10.0
2004	10.1
2005	11.3
2006	12.7
2007	14.2
2008	9.6
2009	9.2
2010	10.6
2011	9.5
2012	7.7
2013	7.7
2014	7.3
2015	6.7

SOURCES: *ZHONGGUO TONGJI NIANJIAN* (2015, P. 64); NBS (2016).

241 In estimating gross capital formation, we do not include inventory accumulation. During the 1980s inventories accounted for, on average, 7 percent of GDP. They were essentially abolished during the SOE reforms in the late 1990s and have, since 2000, only averaged 2 percent of GDP.

The 2008 financial crisis aggravated the problems. Faced with the risk of an economic slowdown caused by the global financial crisis, the government decided to implement an enormous stimulus package of 4 trillion RMB (US\$616). Most of it was earmarked for infrastructure development (Brødsgaard et al. 2016). Since the infrastructure-related sectors (including water and environment, electricity, gas, transport) in China are dominated by SOEs, the stimulus package benefited large SOEs. In contrast, the largely private manufacturing sector was, except in the case of a few industries, excluded from the stimulus package. Statistics show that due to the stimulus package the fixed investment growth rate of SOE fixed asset investment surged to a record high of 35 percent, while fixed asset investment in infrastructure-related sectors alone grew by 43 percent. In 2009 investments reached a share of 44.1 percent of GDP—the highest share in the six decades of China’s economic development. In 2010 the share increased even further to almost 44.6 percent (see Table 12).

TABLE 12 *Chinese capital formation 2000–2015 (share of GDP (%))*

Year	Gross capital investment	Fixed capital investment	Inventory
2000	33.9	32.9	1.0
2001	35.9	33.8	2.1
2002	36.5	35.4	1.1
2003	39.9	38.5	1.4
2004	42.2	39.9	2.3
2005	40.5	39.5	0.9
2006	40.0	38.9	1.2
2007	40.7	38.1	2.6
2008	42.6	39.4	3.2
2009	45.7	44.1	1.6
2010	47.2	44.6	2.7
2011	47.3	44.5	2.8
2012	46.5	44.5	2.0
2013	46.5	44.6	1.9
2014	45.9	43.9	2.0
2015	44.1	42.5	1.6

SOURCE: *ZHONGGUO TONGJI ZHAIYAO* (2016, P. 37).

Efforts to deal with China's dualistic economic structure (i.e. spatial economic disparity) did seem to have some effect. After 2003, the rate of divergence between rural and urban incomes slowed down markedly, and limited convergence even occurred from 2009 onward. However, in 2011, the last year of the Hu and Wen administration, average rural incomes still only amounted to a third of average urban incomes (NBS 2013, table 11-1). Whereas rural tax reform and the expansion of investment in China's countryside and inland regions did diminish inherent urban bias, institutional constraints on the mobility of agricultural workforce continued to undermine the emancipation of the rural population.<sup>242</sup> Nevertheless, construction within China's rural and inland regions created new demand for investment, pushing the rate of fixed capital formation ever upward.

In a similar vein, the development of indigenous innovative capacity has been characterized by a significant absolute increase of industrial innovation related activity, but overall progress has been limited. Aggregate enterprise expenditure on research and development (R&D) surpassed that on technological transformation,<sup>243</sup> suggesting reduced reliance on extant technology in favor of autonomous development. However, an examination of patent grant data suggests that the vast majority of these activities concern incremental developments of extant products or technology, or changes in design.<sup>244</sup> Thus, it appears that efforts to develop China's high-tech industries have been more instrumental in increasing production, rather than truly nurturing indigenous capacity for innovation.

## Conclusion

Although fiscal recentralization under Jiang had curbed indiscriminate local investment in industry and thereby attenuated systemic inflationary tendencies, the long-term prospects of the economy were undermined by the

<sup>242</sup> These constraints will be discussed in the subsequent section.

<sup>243</sup> In 2003 total expenditure of large and medium-sized enterprise on technological transformation and R&D stood at 189.6 and 72.1 billion yuan respectively. By 2010, expenditure on R&D increased to 401.5, surpassing total expenditure on technological transformation by some 37.6 billion yuan (NBS 2011, table 2-1.3).

<sup>244</sup> In 2010, of total patents granted to Chinese enterprise, 46.2 percent were utility patents (i.e. incremental improvements of extant products or processes), design patents accounted for another 43 percent. Only 10.8 percent of patents granted were classified as innovations (State Intellectual Property Office of the PRC, <http://www.sipo.gov.cn>).

persistent reverberations of the strategy of accelerated accumulation. The unrelenting focus on the expansion of heavy industry had led to the neglect of agricultural development. Moreover, due to concentration of industry in coastal and urban areas, uneven sectoral development was reflected in China's geographical composition, resulting in a distinctively dichotomous economic structure. The scientific development concept, emphasizing the development of China's rural and interior regions, suggested a departure from policies emphasizing the expansion of urban industry. These new measures were widely hailed by both domestic and foreign observers as a major advance toward more equitable sectoral relations (Day 2013). Concurrently, leadership sought to bolster overall productivity and international competitiveness by redirecting investment from capital- to technology-intensive industry. However, enthusiasm for the ostensible shift in economic regulation was not ubiquitous. While most of China's economists approved of the objectives of more equitable development in principle,<sup>245</sup> reform-minded economists were skeptical of the state's interventionist orientation. In their opinion, the success of the transition toward more equitable and efficient economic growth depended ultimately on the continuation of institutional reforms (Zhang 2005; Fan 2008; Li 2008).

At first glance, the introduction of scientific development did appear to be accompanied by certain significant institutional advances. After years of contention between the Party's conservative and progressive factions, a Property Law was drafted in 2004. Yet further controversy delayed adoption of the law for another three years. The law guaranteed private rights to income, real estate and capital, as well as savings and investments.<sup>246</sup> Although the official recognition of private property was significant from an ideological standpoint, it had little bearing on the actual operation of the economy. Rather than truly prompting institutional change, the law amounted to a *de jure* acknowledgment of individual economic rights that had essentially been uncontested since the constitutional recognition of the private economy. At the same time, the state had maintained its control over financial markets and key economic sectors, perpetuating the unequal access to resources within the public and private industry. Likewise, adjustments to the household registration system

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245 Fan Gang, a former researcher of the Chinese Academy of Social Science and cofounder of the Unirule Institute, provides a notable exception. In an article written with Xiaolu Wang, Fan argues that initial socioeconomic divergence was a natural concomitant of the transition toward industrialization. A premature preoccupation with more egalitarian development would stymie economic growth and inevitably obstruct China's convergence with fully modernized Western economies (2004).

246 "Zhonghua renmin gongheguo wuquanfa" (2007, articles 64–5).

reflected the reality of loss of central control over migratory movement, rather than the emancipation of rural workers. The “Decision on Certain Major Issues regarding the Promotion of Rural Reforms” of 2008 called for the:

[U]nification of rural and urban societal management, advancement of reform of the household registration system, broadening of the conditions for settlement in small and medium sized cities, and the orderly transformation of rural to urban registration status of persons who have stable employment and residence in towns and city.<sup>247</sup>

In order to facilitate urban settlement and promote the development of scale-efficient farming, the Decision also sanctioned the transfer of usage rights of farmland. Nevertheless, the flow of labor from the countryside to the city continued to be impeded.<sup>248</sup> Reforms did not extend to taxation, employment and welfare policies (administered by different administrative entities), so that divergences between the rights of registered urbanites and rural migrants persisted (Hu 2009). Moreover, ownership of rural land remained invested within the collective, diluting individual farmers’ incentives to engage in efficiency-enhancing investments (Yu 2010).

By the end of the 11th Five Year Plan period, even central leadership had to concede that measures introduced under the leadership of Hu and Wen had been ineffectual:

[We] must clearly observe that the problems of unbalanced, non-harmonious and unsustainable development are still obvious; primarily, resource-related and environmental constraints on economic growth have intensified, the relationship between investment and consumption is unbalanced, income disparity is comparatively large, the capacity for innovation is not strong, industrial structure remains irrational, the agricultural basis is still weak, the development of cities and countryside and regions is unequal, employment pressure coexists with structural

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247 “Tuijin nongcun gaige fazhan ruogan zhongda wenti de jue ding” (2008). Experimentation had commenced in 2005, when 13 provinces, autonomous regions and municipalities had proceeded with adjustments to the system of administrative segregation of rural and urban residents.

248 Large cities, fearing the destabilizing socioeconomic consequences of the abrogation of household registration, were loath to engage in reforms. Furthermore, in affluent regions conditions for eligibility of the transformation from rural to urban status have remained prohibitively high for the vast majority of rural residents (Kam and Buckingham 2008).

contradictions, social contradictions have clearly increased, and there are still many institutional obstacles that impede scientific development.<sup>249</sup>

Nevertheless, the 12th Five Year Plan, issued in May 2011, continued to adhere to a strategy of promoting domestic demand and sectoral restructuring by way of intensified state coordination. The economic paradigm that developed in the wake of the structural reforms of 1998 and was consolidated under Hu—with its focus on nurturing new urban areas and industry and deferring consumption for a promise of greater future dividends—echoes the logic of accelerated accumulation, which provided the template for economic development in the planned economy.

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249 “Guanyu zhiding guominjingji he shehui fazhan di shier ge wu nian guihua de jianyi” (2010, ch. 1).

## The Era of Xi Jinping (2012–2016)

Thus, by the time Xi Jinping took over as the new leader of China he was faced with a situation of classic financial repression, namely highly regulated low interest rates, an undervalued exchange rate (encouraging investment in export industries), and continued capital controls. This had benefited the traditional state-owned sector of the economy and had led to a situation of oversupply of energy-intensive and polluting heavy industry and other problems of imbalanced economic development. In the social field, the social fabric and political stability was threatened by huge income disparities. There was a widespread feeling that the broad masses of Chinese consumers had not received their fair share of economic growth. They had experienced higher incomes and a substantial increase in their standard of living, but the share of consumption in GDP had decreased to 36 percent, indicating that investment still took priority.

In particular, President Xi Jinping and Prime Minister inherited an economy characterized by excessive investment and low consumption and showing clear signs of overcapacity. China produced more than half of the world's output of steel, aluminum, cement and coal, and had also seen explosive growth in sectors such as glass industry and paper industry (Haley and Haley 2013; EU–China Chamber of Commerce 2016). As a result of slowdown of economic growth, China was not able to absorb this production output. There was also increasing pressure from international trading partners who complained about Chinese exports at dumping prices.

The first major initiative of the new leadership was to launch a comprehensive anti-corruption reform which was aimed at “flies” as well as “tigers” and was targeted at government and Party officials as well as SOEs. The campaign was followed by anti-extravagance campaign aimed at reducing public spending on banquets, official cars and travelling. However, during most of 2013, Chinese economists and planners concentrated on formulating a new major reform program.

The new reform program was presented at the third plenum of the eighteenth Central Committee held in November 2013. It was a comprehensive reform program containing no less than 340 reform proposals. The program entitled “The Decision of the CPC Central Committee on Some Important Questions concerning Comprehensively Deepening Reform” was allegedly the result of more than half a year's drafting under the supervision of Xi Jinping (*Xinhua* 2013).

The Decision of the third plenum changed the wording concerning the role markets play in the Chinese economic system from “basic” to “decisive.” The notion of the “supplementary” role of the market in resource mobilization and allocation was written into the Constitution in 1982 (Brødsgaard and Grünberg 2014). Since then several Party congresses “upgraded” the role of the market in their programs. In 1988 the Constitution was amended to include the private sector as a “complement” to the socialist economy and in 1993 the concept of the “socialist market economy” was introduced. In November 1993 the third plenum of the fourteenth Central Committee adopted a Decision which stipulated that the market was to play a “basic” role (*Renmin Ribao* 1993). The Decision of the third plenum in November 2013 went a step further by underlining that market-based price mechanisms were to be applied in all instances where “the market can determine the price,” including natural resources and energy (article 10). Better integration of internal markets in order to address market distortions across regions in China was planned. Also, more unified foreign capital entry regulations, a general opening up toward outside financial markets and even the systematic preference of finance were mentioned (article 12). In terms of rhetoric the Decision goes further than at any time in PRC history in terms of official focus on market regulation and market prices. Not even the 1956 debate on the role of market went this far.

The Decision also signaled important reform in the state sector of the economy. The most far-reaching proposal was to establish a mixed ownership system, including allowing investments in publicly owned entities by private capital (article 6). The aim was to abolish the monopoly status of SOEs and introduce competition in sectors formerly monopolized by them. The Decision also introduced a classification of “monopoly enterprises” and “competitive enterprises.” SOEs in natural resources and public utilities would be considered natural monopolies. However, in the future they would be exposed to market-based pricing of oil, electricity and water and no longer enjoy subsidized access to these resources. They would also have to separate government administration and business operation, while also reforming selection, evaluation and remuneration of management (article 7). “Competitive enterprises” would be exposed to competition and marketized resource allocation and would be allowed to hire executives with salaries based on market criteria. The overall aim was to shift the focus from asset management to capital management. This was a policy proposal put forward earlier by Chen Qingtai, who worked closely with Zhu Rongji and who is still regarded as an influential advisor to the State Development Research Center (Chen 2012). Some Chinese economists also mentioned Singapore’s Temasek Holding as a future model for how the State Assets Supervisory and Administration Committee (SASAC) could manage



the large Chinese central enterprises that form the core of the Chinese SOEs (SASAC 2012).

The Decision underlined the importance of establishing a mixed ownership system which would allow private capital to invest in publicly owned enterprises. Allowing private investment into SOE would mean a substantial upgrading of the role of private capital in the Chinese economic system. These investments could take the form of minority private shareholding in SOEs or the establishment of cooperative state–private ventures. Although this reform entailed significant changes in the role of private capital, a privatization program involving private control over major SOEs was not on the agenda.

Reforms of banking and financial regulation also figured prominently in the reform document. Competition in the financial sector was to be stimulated and small and medium-sized private banks would be allowed to open, providing private enterprises with better access to loans. Of particular importance was a stipulation that interest rates were to be liberalized. According to Central Bank Governor Zhou Xiaochuan this reform would be implemented within a two-year period. If fully implemented such a reform would involve a basic change of the mechanism of financial repression.

The Decision seemed to indicate a commitment to finally implement SOE reform. This impression was reinforced by public statements and interventions by Chinese officials and scholars in late 2013 and early 2014. However, from late 2014 the debate shifted in the direction of consolidation of SOEs rather than breaking them up into competing units. The stated intention was to merge companies in order to create even bigger monopolies within sectors such as telecom, oil and gas, shipbuilding, power generation and so on. In official statements such mergers are necessary in order for Chinese “national champions” to be able to compete at the global-level playing field where the competition is vicious (*elie*). During 2015 and 2016 mergers included COSCO and China Shipping, China Nuclear Power Investment Group and Nuclear Power Technology Group, Wuhan Steel and Baosteel. Mergers and acquisitions on this scale will work against the spirit of the Decision to create competition and possibly break up SOE monopolies into smaller units.

However, it is noteworthy that the Decision did not mention the conflict between lower economic growth rate and excess capacity that Wen Jiabao had discussed in his report on the work of the government in spring 2013. Dealing with this problem involved the SOEs, as it was primarily companies within the state sector that were engaged in excess production and were unwilling to reduce output.

In 2014–2015 the Chinese economic growth rate entered a downward spiral and at the end of 2015 the growth rate had slowed down to 6.7 percent,

the lowest since 1990 (see Table 11). However, even though domestic demand had fallen and export was declining due to weakened international demand, SOEs were reluctant to cut down on production. The government had to step in and implement a policy of reduction of overcapacity and excess production. The policy was first mentioned at the fifth plenum of the eighteenth CCP Central Committee in late October 2015 under the name of supply-side structural reform (*gongji ce tizhi gaige*). Shortly after the plenary session, Xi Jinping, at a meeting of the Central Leading Small Group for Finance and Economics, delivered a speech stressing the importance of supply-side structural reform (Naughton 2016b). Yang Weimin, the vice-director of the Leading Small Group, underlined that stimulating demand was no longer the focal point of economic reform and policy, and at the annual Central Economic Work conference held in December 2015, supply-side reform was defined as a framework and guide for China's future growth.

According to Yang Weimin, supply-side reforms include “four annihilation battles”: (i) eliminate excess capacity; (ii) reduce costs (for companies); (iii) reduce excess housing stocks; and (iv) contain financial risks.<sup>250</sup> Reforms in the battle against costs are mainly aiming at reducing costs for companies. This includes lowering taxes and easing financial burdens and labor costs. In particular, SOEs are supposed to undergo processes of cost reduction (Sina Finance 2015). Reducing housing stocks is primarily aimed at reducing stocks of unsold housing in second- and third-tier cities. Especially the inventory of real estate held by public organs and SOEs is targeted. Local governments and SOEs have long used real estate as investment, but, with increasing oversupply, real estate has become a liability for many companies who were not supposed to engage in real estate speculation in the first place.<sup>251</sup> Deleveraging or containing financial risks involves restructuring debts. Some companies are deeply in debt and local governments have also developed huge debt burdens.

Eliminating excess capacity is perhaps the most important part of supply-side reform. It takes center stage because as the Chinese economy has slowed, demand for heavy-industrial products has dropped, even though capacity has continued to grow. The result is massive overcapacity, especially in steel and coal. In the case of steel China now produces more than half the world's production. Hebei alone produces almost four times as much steel as the USA. The Chinese government has established a target of 100 to 150 million metric tons of capacity reduction within the next three years. Coal is next in line, with projected closures of mines in Inner Mongolia, Shanxi and Shaanxi. After steel

250 See “Yang Weixin xiangjie gongji ce gaige: da sige ‘jianmie zhan’” (2015).

251 “Xi Jinping ti sige jianmie zhan loushi qu cun weilie qizhong” (2015).

and coal, it is the intention to deal with overcapacity in cement, chemicals, electric power and non-ferrous metals.

### Massive Overcapacity

A report from the European Union Chamber of Commerce in China released in spring 2016 outlined the extent of the problem in eight sectors: crude steel, electrolytic aluminum, cement, chemicals, refining, flat glass, shipbuilding, paper and paperboard (European Union Chamber of Commerce in China 2016). The report defines excess capacity as the difference between production capacity and actual production. The report noted that overcapacity is not a new phenomenon. In fact, even in 2009 the Chinese government admitted that overcapacity had become a serious problem and that local governments were continuing to expand capacity “blindly” (ibid., p. 5). The EU Chamber of Commerce in China at the time released a report that provided recommendations as to how the problem could be brought under control. These recommendations, as well as the report, were presented to the EU–China Summit that took place in Nanjing in November 2009 (ibid., p. 1). Yet despite an awareness of the problem no concentrated efforts to remedy the situation were made. In fact, while red signals were hoisted, the Chinese government rolled out a massive stimulus package that benefited these sectors, creating even greater overcapacity.

According to the EU–China Chamber of Commerce report, by 2014 the steel sector was producing yearly 813 million metric tons, more than half global output or more than twice the combined output of the next four biggest steel producers: Japan, India, the USA and Russia.<sup>252</sup> Actually China’s steel mills had a combined output capacity of 1.14 billion tons. Consequently, the utilization rate was only 71 percent, indicating massive excess capacity. In other words, China in 2014 had an overcapacity in the steel sector almost equal to the combined output of Japan, India, the USA and Russia.

China’s electrolytic aluminum industry also has shown rapid growth in recent years. The country now accounts for half of global production. According to the report the industry has a capacity of 38.1 million tons, but only 28.9 tons were produced in 2015, resulting in a utilization rate of 76 percent. China is also a global leader in cement production, accounting for 57 percent of global output. In fact, in the three years between 2011 and 2013 China used more cement

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252 In 2000 China only produced 129 million tons of steel (Kroeber 2016, p. 50).

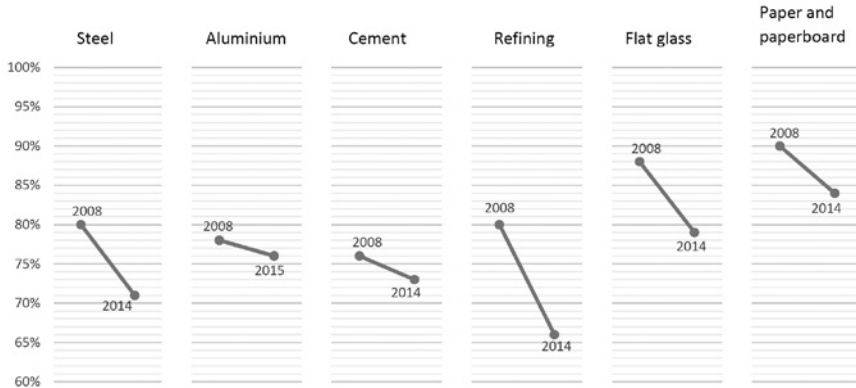


FIGURE 13 Utilization rates for six industries (%).

SOURCE: EUROPEAN UNION CHAMBER OF COMMERCE (2016).

than the USA did in the entire 20th century.<sup>253</sup> The capacity of the Chinese cement industry is an enormous 3.1 billion tons. In 2014 the country “only” produced 2.25 billion tons, a utilization rate of 73 percent. Similar to steel and aluminum, the cement industry had shown significant excess capacity in 2008, yet the problem was not addressed and investment continued to be poured into these crisis-stricken sectors.

The report also discussed the reasons for the outlined overcapacity. It mentions that excess capacity was a problem long before 2008 but the global economic downturn following in the wake of the global financial crisis aggravated the issue. In the late 1990s Zhu Rongji tried to deal with a somewhat similar crisis by shutting down numerous SOEs and laying off almost 40 million workers in the state sector. This was his way of dealing with the severe overinvestment problems. The report argues that from 2002—when Zhu Rongji had stepped down—China’s state-owned heavy-industrial economy experienced a new boom and within the space of five years the relative size of heavy-industrial production in the economy nearly tripled (*ibid.*, p. 8). Before the global financial crisis China was able to export a significant part of the goods that the domestic economy was not able to absorb. With the recent downturn in exports as result of less demand from global markets, especially the EU and the USA, China can no longer use exports as a “safety valve.” Moreover, the low export price of steel and other products are hurting the domestic industry in these markets, creating demands for measures against what is perceived to be unfair competition by China.

<sup>253</sup> These are estimations by Vaclav Smil cited in Kroeber (2016, p. 277). See also Swanson (2015).

## Zombie Enterprises

A central plank of China's supply-side reform is the reform of China's c.150,000 SOEs, and in particular getting rid of the so-called zombie companies. These are companies that have suffered losses for a long time. They consume a large amount of resources, such as land, funds, energy and labor, reducing the efficiency of resource allocation and preventing resources being directed to sectors of higher economic efficiency. Although they have no way to continue their operations, they have not declared bankruptcy. They have been able to use bank loans or government funding to survive. Often local governments are reluctant to see them close down and make great efforts to bail them out as closure will create unemployment in the local area as well as reduce the local tax base.

Longmay Group, for example, is the largest coal company in northeast China. The Group reported large net losses in 2012 and 2013. In 2014 losses increased to 6 billion yuan (Wang 2016). The production capacity of Longmay is only one tenth of Shenhua Group, the leading company in the coal sector, but both companies employ about 200,000 workers. In October 2015 it was reported that Longmay planned to lay off 100,000 workers (Hornby 2016). However, according to company statements many of the workers would be diverted to affiliated companies, a sign of political pressure to maintain jobs and avoid unemployment in a region which is struggling to keep up with the more dynamic regions in southern China. Laying off workers may cause protests by those affected. This in fact did happen in the case of Longmay.

The governor of Heilongjiang, Lu Hao, claimed during the meeting of the National People's Congress in Beijing in March 2016 that no miner working for Longmay was owed any back wages. Lu Hao's statement was met with strong protest from thousands of miners who, the following day, marched through the city of Shuangyashan and gathered in front of the company's local offices demanding to be paid. In response the provincial government issued a statement acknowledging that the governor had been misinformed and that Longmay in fact had failed to pay wages and insurance contributions. The statement also said that the government would cooperate with Longmay to raise money to pay the workers in time (*Taipei Times* 2016).

In January 2016 a report from China International Capital Corp. claimed that 3 million jobs of the 10 million currently available in the coal, steel, aluminum, cement and glass industries would be cut over a three-year period (EU-China Chamber of Commerce 2016, p. 44). This is the first time since Zhu Rongji restricted the state sector in the late 1990s that the Chinese government is laying off workers in large numbers. The government is clearly aware of the problems

this may create and is busy softening the economic repercussions for the workers affected. In his report on the work of the government delivered to the fourth session of the twelfth NPC on March 5, 2016, Premier Li Keqiang mentioned that 100 billion yuan in rewards and subsidies would be provided by the central government (Li 2016). These funds would mainly be used to resettle employees laid off from SOEs. In May 2016, the Ministry of Finance said in a statement that 80 percent of the funds would be distributed to local governments and central enterprises based on their capacity, reductions assignments and the number of workers that would be laid off. The rest of the funds would be used as a form of bonus, to be allocated based on how well local governments and SOEs fulfilled their assignments (*Beijing Review* 2016).

Supply-side reform is a top-down initiative emerging from the central government in Beijing. However, the implementation of the program is to be undertaken by provincial governments in provinces where most industrial companies engaged in excess production are physically located (Naughton 2016a). Consequently, each province must draft plans for cutting down on heavy-industrial capacity. Hebei, which produces almost one quarter of China's steel output, has agreed to reduce its steel production by 49 million tons by 2020 and 14 million tons by 2016.<sup>254</sup> Other steel-producing provinces, such as Shandong and Jiangsu, have agreed to reduce output by 16–23 percent within the 13th Five Year Plan period (2016–2020). As provincial leaders are eager to be part of the comprehensive round of promotions that will take place in connection with the 19th Party congress, they are strongly motivated to follow central policies.<sup>255</sup> However, in doing so they are confronted with powerful vested interests that feel hurt by production cuts.

Supply-side reform will mainly affect the SOEs. There are 150,000 of these and they are found at both central and local levels. The most important are the 106 so-called central enterprises that dominate the strategic sectors of the economy and in fact enjoy a monopoly status. Industries such as steel, cement and glass are highly fragmented, with multiple comparatively inefficient small local enterprises. Many of these will now be closed down and local governments will have to work out plans for how this is to be done. At the central level the government will pursue a different policy. As mentioned above, the current strategy is to merge many of the large SASAC companies in order to

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254 "Quanguo gedi gangtie qu channeng zhengce chulaile!" (2016).

255 Five provincial leaders are members of the Politburo and are possible candidates to enter the Standing Committee of the Politburo at the nineteenth Party congress in 2017. These are Guo Jinlong in Beijing, Han Zheng in Shanghai, Hu Chunhua in Guangdong, Sun Zhengcai in Chongqing and Zhang Chunxian in Xinjiang.

create even bigger monopolies. The intention is to strengthen the international competitiveness of China's "national champions." Moreover, central SOEs will be allowed to make acquisitions among companies on the list of those to be closed or phased out. Such mergers and acquisitions will work against earlier plans to break up SOE monopolies into smaller units.

For decades SOEs in China have enjoyed preferential treatment. The Decision of the third plenum seemed to indicate that the private sector in the future would enjoy better treatment. In his 2016 government work report, Li Keqiang argued that the government would energize private companies by allowing them to compete with SOEs. This makes economic sense as private companies in China in general are more profitable than SOEs. However, politically the state sector is still considered the heart of the economy. Thus, private capital will not be allowed to play a significant role in any of the strategic sectors currently dominated by the 106 central enterprises or "national champions." The Party realizes that, left on their own, the SOEs are not yet able to weather the fierce competition on the global-level playing field. Almost half of the central enterprises are on the Fortune 500 list, where China now has 103 companies. Three of them are among the top ten companies in the world according to the list.<sup>256</sup> In terms of revenues and size of the workforce they are big. However, they are weak in terms of R&D and branding (Nolan 2012). This is a major impediment to their ability to succeed and therefore they need to be supported by the state via cheap bank loans, and preferential access to land and low-priced energy sources. The funds for all this come from the Chinese consumers and are made available by the mechanism of financial repression.

### 13th Five Year Plan and New Normal

Supply-side reform in China is part of part of Xi Jinping's framework for the so-called New Normal. This is a policy which projects an economic slowdown, from double digit growth during the 1990s and 2000s to an annual growth rate of around 6.5 percent during the period of 2016–2020. According to the 13th Five Year Plan, adopted at the NPC in March 2016, and the First Five Year Plan, worked out under the direction of the Xi–Li leadership, the slowdown involves a restructuring of the economy toward a more balanced, green,

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256 In 2001 China only had ten companies on the Global Fortune 500 List. China now has twice as many on the list as Japan (52 companies) and is rapidly catching up with the USA (134 companies). State Grid, CNPC and Sinopec are numbers two, three and four on the list, only surpassed by Walmart. The list is available at: <<http://beta.fortune.com/global500/list>>.

consumption-driven, innovative and service-oriented development path (*Xinhua* 2016). This involves focus on green and innovation-driven development, upgrading of the industrial structure and output, increasing the contribution of consumption to economic growth and reducing the role of investment, raising people's living standard and quality of life, eliminating remnants of rural poverty, advancing environmental protection and modernizing the national governance system. In order to make sure that Party and state officials follow the line and do not engage in corrupt and wasteful practices, the Five Year Plan also stipulates that the current anti-corruption campaign will continue. Except for the part on anti-corruption, many of these elements were already part of the 12th Five Year Plan, worked out under the previous leadership team of Hu Jintao and Wen Jiabao and covering the 2011–2016 period (“*Zhonghua Renmin Gongheguo*” 2011).

One of the more prominent policy initiatives mentioned in the 13th Five Year Plan is the so-called “One Belt, One Road” initiative. The One Belt, One Road concept was first presented in September–October 2013 during Xi Jinping's visit to Kazakhstan and Indonesia (Swaine 2015).<sup>257</sup> The idea is to connect China, Asia and Europe in terms of trade and economic interaction via a land route (“the belt”) as well as a maritime route (“the road”). The Chinese government has established a development fund of \$40 billion to finance some of the initial projects connected with the initiative. The 13th Five Year Plan states that China intends to build an infrastructure network connecting every Asian subregion and linking Asia, Africa and Europe. In cooperation with countries taking part in the project, it involves establishing road, railroad, water and airway links, and building logistic corridors. The plan specifically mentions the construction of following economic corridors: the China–Mongolia–Russia Economic Corridor (CMREC), the New Eurasian Land Bridge (NELB); the China–Central and West Asia Economic Corridor (CWAEC); the China–IndoChina Peninsula Economic Corridor (CIPEC); the China–Pakistan Economic Corridor (CPEC), and the Bangladesh–China–India–Myanmar Economic Corridor (BCIMEC). As part of these, major infrastructure projects such as port infrastructure and industrial hubs will be constructed.

The countries potentially part of the One Belt, One Road initiative include 60 emerging market countries and developing countries with a total population of 4 billion, more than half the world's population, and an economic aggregate of \$21 trillion, almost a third of global GDP. Given its geographic scope and the number of countries and people involved, Wu Jianmin, former ambassador to

<sup>257</sup> The Silk Road Economic Belt was unveiled at Nazarbayev University, Kazakhstan, in September 2013. The New Maritime Silk Road was announced before the Indonesian Parliament on October 3, 2013.



France and former president of China Foreign Affairs University, has described the One Belt, One Road project as “the most significant and far-reaching initiative that China has ever put forward” (Wu 2015). One might add that if all these plans materialize, huge construction works will be needed, requiring steel, cement, aluminum and other products in sectors that are plagued by overcapacity in the domestic Chinese market. Thus, a successful One Belt, One Road initiative will help China minimizing its problem of excess capacity.

### Conclusion

Chinese economic development has come full circle. In spite of official rhetoric fixed capital investment has consistently been kept at high levels and reached 44.6 percent of GDP by 2010. Only in the early 1960s was it possible to reverse the trend, but the outbreak of the Cultural Revolution made it impossible to sustain a readjustment policy based on a comparatively low investment rate, a reordering of sectoral balances and agricultural reform. When investment, in the 1990s and especially the 2000s, significantly began to rise again, the accumulation mechanism shifted from the traditional price-scissor of transferring resources from agriculture to industry to a mechanism based on financial repression. As a result, farmers and the agricultural sector are no longer alone in transferring resources to the industrial sector. In fact, the broad masses of consumers, through their savings, are making continued state support of heavy industry possible.

The accumulation model also has a political dimension. The state sector is of crucial importance to the ruling party. State ownership and SOEs are supposed to reflect a higher stage of socialist development than other forms of economic ownership and economic organization. The state sector is also an important recruitment base for future Party and state leaders. The so-called “national champions” are all state-owned companies and they totally dominate the strategic sectors of the economy. The communist regime will not be able to survive an abolishment of the SOEs and a full-scale privatization of the economy. Party leaders are keenly aware of this, yet there is an urgent need to change a development strategy that has run out of steam. Consequently, selected reforms, such as supply-side reform, and a change of the mechanism of financial repression are needed. At the same time, it is realized that implementation is crucial to sustained change. For decades Chinese economic development has relied on resource mobilization. Now it is time to change to resource efficiency.

## Discourse and Development: Insights and Issues

### Introduction

At the outset, we claimed that an understanding of Chinese economic discourse, its origins and evolution can provide valuable insight into the way China's political elite thinks about the economy, the objectives and mechanisms of governance, and, by extension, the ongoing transformation of the economic system. Those who study China's amalgam of market institutions and authoritarian administration have sought to capture its defining characteristics through a variety of terms, ranging from "Sino-capitalism" (McNally 2012) to the improbable oxymoron of "state neoliberalism" (Chu 2010). Notably, few outside observers have seen fit to define this system by its official appellation: the socialist market economy (*shehui zhuyi shichang jingji*). Yet, closer examination of this concept and its position within the greater system of central economic discourse reveals deeply entrenched motives and assumptions about the working of the economic system that would likely be glossed over by the Western perspectives discussed in the Introduction, which focus on the self-enforcing constraint of efficiency or the distribution of political power within an authoritarian system. One criticism we levelled against these approaches was that they are (implicitly) biased toward the post-Mao period of reforms and emphasize change over continuity. While the history of the concept of the socialist market economy spans just over two decades, the debates that shaped its defining features hark back to the early years of the establishment of the People's Republic. Within Chinese economic thought, the notions of accumulation, readjustment and reform in particular have been instrumental in shaping elite conceptualizations of economic development and governance. Although the scope and meaning of these concepts have been gradually redefined in response to the changing structure of the Chinese economy and its problems, they have been the red thread that runs through six decades of economic policy. As such, a thorough appreciation of Chinese economic discourse—which originated in the early years of the People's Republic—is indispensable to an understanding of the major changes and continuities in China's idiosyncratic economic system.

### Readjustment and Reform: From Plan to Socialist Market Economy

The notions of accumulation, readjustment and reform first appeared shortly after the adoption of the First Five Year Plan. In this formative period, the singular focus of Mao and his economic commandants was on the rapid establishment of a modern, industrialized economy. Economic discourse revolved around three major concerns. First was the matter of sectoral relations. Some economists and planners were adamant about the need for a balanced and proportionate trajectory of development given the low productivity of agriculture. However, Mao, inspired by the theories of Preobrazhensky and Fel'dman, insisted on a pattern of accelerated accumulation, whereby agricultural capital would be transferred to industry through an elaborate system of price manipulations. The mobilization and transfer of capital necessary to realize the expansive growth of industry required extensive central control over production and allocation. This technical requirement coincided with the ideological imperative to abolish private property, prompting the Party to rapidly proceed with the annexation of the means of reproduction. This pitted Mao against leaders in the economic bureaucracy (notably Chen Yun), who felt that an underdeveloped understanding of technical factors within the public economy had resulted in inefficient production processes, and who consequently argued for the partial reinstatement of market relations. Such proposals were anathema to Mao's interpretation of Marxism–Leninism, which held that the success in achieving rapid industrialization depended crucially on perfecting the socialist consciousness of the Chinese people. The strategy of readjustment (balanced and proportionate development) was formulated in 1956 in response to lagging productivity in the agricultural sector and comprised of two elements. First, accelerated accumulation was to be abandoned in favor of proportionate development of the sectors of the economy and, second, the overall investment rate was to be reduced so as to increase household consumption. Reform, that is, the partial reinstatement of market exchange and private property (initially in agriculture) was seen as a natural complement to readjustment because market production would incentivize idle rural labor while increasing discretionary income. Readjustment, which was widely implemented in the wake of the Great Leap Forward, also involved a more rigorous planning process. However, readjustment policies were vehemently opposed by Mao, who in 1966 launched the Cultural Revolution.

Mao's death in 1976 provided the necessary political leeway for renewed reform and readjustment policies. Deng and his supporters expended much effort on cultivating a discourse that unequivocally stressed growth as the sole legitimate measure of progress, a position readily accepted by a population

weariness of years of revolutionary struggle and economic stagnation. This is not to say that Deng altogether rejected the primacy of socialism. However, according to Deng, the socialist character of the economy would prevail as long as public ownership continued to predominate. Despite Deng's assault on the revolutionary left, the economics of the Maoist period continued to cast a long shadow over the era of reform. The traditional questions of the relations between sectors and investment and consumption continued to guide policymaking during the 1980s and early 1990s. Moreover, although Deng had successfully positioned himself at the apex of Chinese politics, conservative figures such as Li Peng and Chen Yun continued to hold great sway. When reforms proved incompatible with readjustment because they precipitated inflation and pervasive misallocation of capital, conservative influence, and with it the ideological attacks on the "revisionist" program of Deng and his allies, steadily increased.

While, throughout much of the initial period of reform, the conceptual framework and discourse of the Maoist era would thus continue to hold sway, economic and political conditions in the mid- to late 1980s would put an end to the contention between the reform-minded progressives and the conservatives in favor of readjustment. Neither reform nor readjustment of investment rates in agriculture and industry proved capable of securing the central objective of rapid, but stable growth. While decentralization and marketization resulted in inflation, reintroduction of central planning would invariably cause economic stagnation. The reform program of Chen and Deng was borne out of the tradition of Marxist–Leninist economics, which denied the possibility of inflation within a socialist system. It therefore lacked the conceptual foundations necessary to formulate an appropriate response to the volatility experienced during the immediate post-Mao period of development. Additionally, SOEs' inefficiency and insatiable demand for capital had caused central debt to rise to unsustainable levels. This prompted a search for novel economic frameworks. Encouraged by the prevailing liberal intellectual climate and increasing openness to the West, economists increasingly turned to market-centric theories. Economists and politicians alike readily adopted monetary theory, which provided detailed explanations of, and prescriptions for, the problem of inflation. Property rights literature too filled an important conceptual gap by providing an explanation for the pervasive problems of capital misallocation and non-productive practices at the firm level.

In this period, several influential economists proposed to extend the scope of reforms in order to put the responsibility of resource allocation squarely on markets and the firms operating within them. However, such discussions were brought to an abrupt end by the political protests of 1989. The most ardent

advocates of reform (both economic and political) were removed from their positions of influence. The Tiananmen incident united the remaining leadership in a conviction that the authority of the Party-state in matters both political and economic should remain pervasive and unchallenged. While this did not result in an outright condemnation of Western economic thought, it did convince the leadership that the Party-state ought to remain in firm control of investment and “strategic” sectors of the economy. The resultant paradigm of the socialist market economy, first articulated in 1992 by Jiang Zemin, combined insistence on the incentivizing and disciplinary function of markets and the use of indirect mechanisms of control with a renewed economic authoritarianism. Indeed, within the new “multifarious ownership system” (*duozhong suoyouzh*) non-public forms of ownership would predominate. In addition, administrative coordination was largely replaced by market exchange as the chief mechanism of allocation (Lardy 2014). Nevertheless, through the operation of economic levers (*jingji gangan*) the state was still able to guide the distribution of capital and overall course of development. Indeed, Jiang insisted it was the state’s “capacity for control” that would ensure the enduring socialist quality of the economy.

The policies introduced under the banner of market socialism from the early 1990s onward were effective in curbing economic volatility. Fiscal recentralization eased soft budget constraints within the public sector and curbed rampant discretionary industrial investment by local government. Privatization of loss-making public enterprises and disbandment of the iron rice-bowl system had eased the center’s burden. Moreover, public sector restructuring also provided an opportunity to redefine state–market relations, to the effect of realizing a concentration of capital within public industry. The massive layoffs and defunding of social security that accompanied the privatization drive precipitated widespread uncertainty among the labor force, rapidly driving up savings despite extremely low interest rates. This capital was subsequently funneled into centrally controlled industrial conglomerates, establishing a new price scissors that allowed for the rapid expansion of the center’s economic clout even as private enterprise continued to ensure strong growth. Thus, it appeared that the mode of economic governance that took shape under the paradigm of the socialist market economy had been successful in bringing about the eagerly anticipated result of strong economic performance under a potent and authoritative state.

The economic and political developments of the 1990s are instrumental to understanding China’s incessantly high investment rate. The discontinuation of the factional debate on reform and readjustment and its associated mode of Marxist–Leninist analysis prompted the debate on the respective spheres of

influence of the state and market and property rights to vanish into the background, not to resurface until 2013. In the combination of market exchange and economic levers, the Party-state had found an agreeable compromise between the demands for efficiency and control. Further reforms were suspended as the state pursued a centralist policy of developing large, scale-efficient state-owned conglomerates while devolving expenditures associated with loss-making state enterprise to the private sector. Since the implementation of the policy of retaining the large and releasing the small (*zhua da fang xiao*), little has been done to advance the modern enterprise system, the comprehensive program of public sector restructuring advocated by Zhu Rongji in the early 1990s. Under Jiang, the rapidly expanding private sector was more than able to compensate for the poor performance of SOE. Nevertheless, with the transfer of power from Jiang to Hu, and subsequently to Xi, the limitations of industrial growth became ever more apparent.

Academic analyses from the mid-1990s onward reflected an increasing concern about the detrimental consequences of investment-driven growth. The scientific development concept promoted by Hu Jintao sought to deal with these challenges through intensified administrative regulation of capital allocation. Through centrally formulated programs that combined lump sum transfers with fiscal and industrial policy, the state sought to divert investment toward rural construction, agriculture and “emerging strategic industries.” Unwilling to press on with reforms, the state rather sought to sustain growth through readjustment, that is, by directing investment to relatively underexploited areas of the economy. Thus, even as government sought to deal with worsening socioeconomic inequalities and rampant overaccumulation within heavy industry, it has consistently reverted to measures that rely on the mobilization of capital and build-up of new productive capacity. In consequence, the reciprocal dynamic between elite conceptualizations and economic outcomes that drove the transformation of governance from plan to socialist market has been suspended indefinitely. So has the move away from the entrenched model of investment-driven growth, although some reduction of the excessive investment rate has been seen since Xi Jinping came to power in 2012.

The non-relenting adherence of central government to the principles of state-directed investment, and apparent lack of feasible alternatives, are causes for concern. Although limited progress has been made with reforms along the lines set out by Zhu Rongji, we believe his diagnosis to be correct. Absent the restructuring of property rights, state–market relations and the financial system, there is little reason to expect overinvestment and overcapacity to substantially decrease, or domestic consumption and productivity to increase. However, the window for such comprehensive restructuring is limited. With

overall growth contracting and government debt sharply on the increase, conditions are already considerably bleaker than they were in 1997, when a proliferating private sector could cushion the destabilizing impact of public sector restructuring. Yet, it is unlikely conditions will improve in the foreseeable future. While central support alone does not guarantee the success of reforms, it is, nevertheless, an indispensable precondition to the resolution of the problems intimately associated with the model of state-directed, investment-driven growth. It is therefore of concern that the substantial reform program put forward by Xi Jinping and adopted at the meeting of the third plenary session of the Eighteenth Central Committee in November 2013 has stalled, and in some areas even rolled back.

### Discourse and Politics

Although the general dynamic of paradigmatic development and crisis holds well in our analysis of Chinese discourse and governance, we would be remiss in ignoring the influence of politics. Both the substance of China's economic paradigms and the adoption and succession thereof have been shaped and constrained by political conditions. Perhaps most important of these is the CCP's insistence on political hegemony, which is a primary cause for the tenacious adherence to the principles of accumulation-driven growth. For the Chinese population, the legitimacy of the CCP has long rested on the perception that it plays an instrumental role in bringing about economic growth and improving the quality of life for the 1.3 billion Chinese over which it governs. The CCP on its part has precluded the adoption of any solution that would lessen state influence over the economy. Control is exerted primarily through the economic levers put in place from 1993 onward. This intricate system of financial, monetary and industrial policies was introduced with the explicit purpose of guiding investment and delineating private and public spheres of influence within the economy. These governance mechanisms do ensure that the state retains ultimate authority on economic matters, but render it poorly equipped to promote growth strategies that do not rely principally on the expansion of fixed capital. Yet, in the absence of politically acceptable alternatives to the socialist market economy, the Party-state has been forced to respond to China's economic predicaments with policies that accord with its extant techniques of control.

The ideological uniformity that has characterized elite politics from the early 1990s onward stands in stark contrast to the contention between rival factions that defined the preceding period. Not only did scrutiny by political rivals

condition both sides to continuously adjudicate the efficacy of their proposed programs in the face of current economic developments, but the attendant debate likewise prompted both factions to actively pursue novel concepts and ideas in order to lend new legitimacy to their respective causes. Political competition between rival ideas thus serves an important role in driving the cycle of paradigmatic formulation, establishment and succession, and invigorating discourse. When such competition is curbed—either due to the ideological zeal that characterized the Maoist era or due to the current emphasis on intra-party harmony—the focus on the relationship between concept and actual outcome, as well as the scope for conceptual innovation, suffer.

### Merits and Limitations of Discursive Analysis

Our analysis demonstrated that the consequential changes in the mode of governance cannot be explained on the basis of principles of efficiency or political influence. To be sure, the Chinese case demonstrates that the inherent drive for efficiency which is at the center of the transition and institutional approaches poses but a weak constraint on the modes of economic governance. While highly inefficient forms are unlikely to persist over extended periods of time because they inevitably call into question the legitimacy of dominant paradigms, there is no reason to assume that policy responses to economic imbalances will be instantaneous or necessarily optimal. After all, economic paradigms are ideological constructs; while causal explanations of economic outcomes are central to these paradigms, such explanations may be premised either on empirical evidence or some shared set of values or beliefs. The ideological zeal of the Maoist era allowed suboptimal institutional arrangements to persist—based chiefly on the socialization of consciousness—even in the face of patent evidence of the destructive consequences of a paradigm. No doubt political conditions under Mao were exceptional. Nevertheless, at present political objectives continue to guide and constrain changes of the mode of governance. Thus, in spite of the mounting problems of accumulation-driven growth, the CCP has continued to emphasize its control over investment and sectoral development.

Likewise, our analysis shows that the programs and policies that shaped governance throughout the different stages of economic development were more comprehensive and coherent than could be expected if they had been mere outcomes of political bargaining by different interest groups. Nor can they simply be reduced to expropriatory motives or attempts by rival factions to increase their political stature. Perspectives that present changes in



governance solely as an outcome of politicking between groups with diverging interests would be hard-pressed to explain why the leadership acquiesced with the introduction of reforms and readjustments, even though it would inevitably lead to the attrition of central influence. Rather, such initiatives have to be understood as concerted efforts by political actors to formulate encompassing responses to extant economic problems.

These conclusions about the pursuit of efficiency and interest present a paradox: rational decision-making is constrained by political influence, yet policies do not unambiguously represent political interest. In resolving this apparent contradiction, we turn to discourse. In contrast to the sterile models of actorhood provided by the efficiency and political approach, discourse analysis holds that sensemaking and politicking occur in tandem. The economic paradigms developed by central leadership comprise both the perceived cause and effect relationships within the economic system and the general objectives of economic activity. As such, they provide at once the cognitive and normative underpinnings for policymaking. In certain instances, political positions will take shape alongside competing interpretations of economic phenomena (as was the case with the reform and readjustment factions) or political interests will delineate the set of legitimate representations of, and responses to, emerging economic problems (explaining the state's current approach to the issues of socioeconomic disparity and the transformation of the mode of development). However, more often than not, the processes of sensemaking and politicking will interlace in an organic manner, as ideological convictions shape the manner in which we seek to understand and interact with our social and material environments.

Notwithstanding the merits of the discursive approach in explaining policymaking, we ought not to ignore the interdependencies between discourse, economics and politics. As repeatedly demonstrated in our analysis, elite conceptualizations of the economic system cannot prefigure the dynamics that end up driving economic growth, much less forestall the grave imbalances that periodically emerged. The local experimentation emphasized by more recent versions of fragmented authoritarianism plays an important role in explaining this growth and imbalance. The momentous upturn of economic activity within the rural sector in the late 1970s and 1980s was due in large part to an unanticipated reciprocity between fiscal decentralization and marketization. When local government was granted the right to claim taxes on newly established TVES, their establishment became a major focus of local policy. Likewise, the pervasive privatization that occurred under the guise of "releasing the small" in the late 1990s was driven by local governments eager to supplement their dwindling revenues through the sale of SOE. Thus, while the general char-

acter of state engagement with the economy is determined by national policies, the center cannot often anticipate the manner in which local bureaucracy will utilize its authority.

Due consideration needs to be given to the institutional interdependencies that are the focus of efficiency-based approaches too. Many of the destabilizing dynamics that gave cause for the readjustment of the economic paradigms were due to antagonisms between institutional arrangements within the spheres of capital, labor, and the organization of production and exchange. In the early stages of reform, market relations were introduced while the traditional distribution of financial responsibilities within the public sector remained unchanged. The resulting soft budget constraint prompted an insatiable demand for credit among SOE, resulting in inflationary crises throughout the 1980s and 1990s. While recentralization of the fiscal system and banking restored macroeconomic stability, it likewise precipitated increasing disparity between the private and public economy and rural and urban sectors, undermining social stability. Such imbalances may arise when institutional change proceeds in an asynchronous or partial manner, causing antagonisms between different spheres of governance even as existing ones are resolved.

In sum, we argue that a holistic understanding of the development of the Chinese economy and its associated modes of governance requires in-depth analysis of the elite conceptualizations that describe the objectives and mechanisms of state influence, the manner in which these paradigms are adopted and adapted by the various political and bureaucratic constituents at the central and local level, and the way in which economic institutions interact to create (un)anticipated synergies and imbalances.

### **Dynamics of Discourse: Insights from the Chinese Case**

Although our chief interest has been to describe and analyze China's economic paradigms and their relation to economic governance, our study provides insights into the discursive process too. Here we briefly discuss these insights. We found the general model of economic paradigms to provide a strong fit with the pattern of change of Chinese discourse and governance. The remarkable trajectory of growth over more than six decades of development under CCP rule have been accompanied by destabilizing forces that have necessitated comprehensive periodic adjustments to the state's conceptualization of the economic process and its mode of economic governance. There are, however, several caveats. The first of these relates to the functionalism implicit in the process of paradigmatic succession. No guarantee exists that paradigmatic

crisis will prompt the articulation and adoption of a conceptual solution. Entrenched political positions or interests can prevent alternative paradigms from gaining legitimacy, as was the case with the program of reform and readjustment throughout the era of Mao. Even when political factors do not entirely prohibit the introduction of novel conceptualizations of the economic system, they may well impose constraints and conditions that preclude the articulation of feasible alternatives. Certainly, the impasse of economic governance under the regimes of Hu and Xi is due, to large extent, to the continued insistence on extensive state control over investment and industry, which severely limits the set of possible responses to the problems of dwindling returns in industry and a lack of domestic consumption. The dynamic of crisis, reconceptualization and adoption thus does not necessarily proceed uninterrupted, but may be marked by extended periods of conceptual stagnation.

Qualifications apply also to the locus of change. Although Chinese economic discourse and governance have been characterized by periodic bouts of comprehensive transformation, allowing us to identify three distinct periods, such change has not unfolded synchronically at all levels of conceptualization. As Hall (1993) implies, paradigms are multilevel constructs, comprising ideological and ontological, epistemological and technical dimensions. They delineate the elements (whether abstract or concrete) and relationships between them which constitute the economic system, and from there develop propositional knowledge (specific causal mechanisms) and techniques for manipulating these causal mechanisms in order to achieve some desired result. Rarely does a shift in paradigms signify the simultaneous transformation of all these levels. Often, changes on one level are conditional on changes in others. Under Deng, the delegitimization of Mao's dialectics was a precondition to the substitution of continuous revolutionary struggle with the program of reform and readjustment. After all, the contention between Party and state leaders in the central planning era had not revolved around whether or not sectoral imbalances existed, but rather their significance within the greater economic system. According to Mao, contradiction was a fact of life, which could be overcome through continuous revolution. Only when Deng replaced the socialization of consciousness with pragmatism as the guiding principle, and established the ratio of public ownership as the essence of socialism, could the reforms within agriculture and adjustments to the investment rate proceed.

In other cases, changes may be partial, which may result in disjunctions between the different levels of the economic paradigm. After Jiang, through his third liberation of thought, reduced the quality of socialism to a measure of the state's capacity for economic control, the debate on the ideological foundations of the economic paradigm all but ceased and economic discussions

came to revolve instead around the technical matters of macroeconomic stability and microeconomic efficiency. Consequently, while economic discourse under Hu saw the development of novel propositions about the causes of the mounting imbalances within the economy, these did not prompt a re-evaluation of entrenched (but largely concealed) ontological and ideological assumptions about the role of the state. Because of the maintenance of the ideological status quo, Hu's scientific development concept continued to propagate entrenched centralist measures that sought to promote growth through state-guided investments, despite mounting evidence of the inefficacy of state-guided, investment-driven responses to economic disparity and the dearth of domestic consumption.

Finally, the evolution of economic paradigms is affected by the processes of sensemaking and politicking. In its simplest form, change is effectuated through a process whereby extant propositions are scrutinized against observed phenomena. In the late 1950s, the discrepancy between predicted and actual outcomes of the strategy of accelerated accumulation led to the formulation of reform and readjustment. While this program entailed a consequential reevaluation of the roles of the law of value and accelerated versus balanced proportionate development, the economic categories and relationships which formed the basis of the paradigm remained unchanged. Alternatively, when extant concepts fail to account for observed phenomena, sensemaking and politicking may entail the introduction of novel frameworks. The unprecedented problem of inflation and systemic overaccumulation motivated the introduction of monetary and property rights theory, which in turn gave occasion for the articulation of the socialist market economy. However, the establishment of novel economic paradigms requires not only cognitive but normative change too. Neither the program of reform and readjustment, nor the socialist market economy, could attain legitimacy under prevailing ideological conditions. This prompted both Deng and Jiang to engage in a redefinition of socialism and its relation to the economic system. Subtler still, but not less consequential, was the process whereby ontological and ideological principles were concealed from discourse. Due to the implicit negation of the superstructure (the sociopolitical alignment in which the relations of production are embedded), effectuated by Jiang's third liberalization of thought, elite discourse no longer provided recourse for critical appraisal of the legitimate role of the state within the economic system.<sup>258</sup> In this way, the absence of

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258 Marxist–Leninist theory is still a compulsory element of the education of cadres within the CCP. However, these theories have little to no bearing on either the elite discourse that shapes economic governance or the academic debate that informs it.

discussion of the nature of the economic system has enabled the propagation of a centralist mode of governance even in the face of increasing contradiction.

On the basis of the foregoing, we suggest that attention to the sequence, locus, and cognitive and political dimensions of change could enhance our understanding of why and how economic paradigms evolve. It is worthwhile asking, however, to what extent some of our observations are attributable to the particular nature of Chinese politics. The dearth of competing conceptions within economic discourse are largely due to the absence of political rivals. While intra-Party factionalism provided an alternative drive for discursive contention during the regimes of Mao and Deng, post-Tiananmen politics have been characterized more by internal struggles for political power rather than rivalry between templates for economic organization. The CCP's political monopoly may likewise attenuate the evolutionary pressure exerted by economic imbalances. Whereas in pluralistic systems, non-ruling parties are quick to seize on economic predicaments to call into question the efficacy and legitimacy of incumbent government, in China such external political pressure is absent. The torpor of the general dynamic of paradigmatic change can thus hardly be explained without taking into account China's political institutions. However, even if they do not exist to the same degree as in China, obstacles to political contention are pervasive in multiparty systems too. Therefore, we believe our insights into the discursive process to have merit beyond the Chinese case.

### Conclusion

The literature on Chinese economic development is expansive and, considering China's ongoing growth and its increasing stature within the global economy, is surely set to continue to develop rapidly in years to come. While there is no shortage of policy studies or historical narratives, we have sought to complement the literature with an analysis of the development of China's economic discourse and governance from the establishment of the People's Republic onward. The emphasis on economic paradigms illuminated aspects of the character and dynamics of economic governance and development that cannot be adequately captured by perspectives that only stress the pressure for institutional efficiency or competition for influence by central and local political actors. It likewise allows us to understand why certain ideas continue to shape governance even as they appear to contradict the economic diagnoses of China's economic leadership.

Such an approach focusing on economic discourse and development paradigms—or ideational factors in Sarah Eaton’s parlance—needs to take into consideration that Chinese economic plans and decisions are framed within the context of Marxist concepts and terms, although Western neoliberal ideas from the 1990s have increasingly influenced the economic policy debate. In a more general sense, our analysis suggests that studies of economic governance ought to be informed by both contextual knowledge and general dynamics. The study of discourse captures both the particular, path-dependent development of ideas, and the generic processes of sensemaking and politicking that drive the change of economic development.

Arguably the most salient proof for the persistence of the template of capital-intensive, industry-centric growth has been the failure to realize the original objective of readjustment, formulated some five decades ago. Despite leaderships’ insistence on the importance of increasing the rate of consumption and promoting the development of agriculture, the rate of GFCF has continued to rise, and all the while agriculture’s share of GDP has been declining. Although reforms were initially regarded as a necessary expedient for readjustment, the reorganization of the financial regime and industrial relations has rather proved instrumental in sustaining the expansion of industrial capacity. After more than a decade of Keynesian central policy and limited institutional change, increasing socioeconomic inequality and slowing growth seem to espouse a growing conviction among economic leadership and economists alike that comprehensive expansion of market exchange and private property rights—of the sort discussed during the fourteenth Party congress of 1994—are necessary to sustain economic development.

This conviction was the driving motivation behind the formulation of the comprehensive reform program adopted by the third plenum of the Central Committee in November 2013. That most of the proposals have not yet been realized is, once again, a reflection of the fact that economic debate and policy implementation often do not follow in tandem. It also reflects the power of centralizing forces embedded in a polity which continues to be dominated by a Leninist Party organization.

This study also shows that although the CCP has maintained a strong unitary power over Chinese society and has exercised a dominating and hegemonic influence on economic policymaking, in general a lively debate has taken place in Chinese scholarly journals and in print media on the goals and directions of economic development. To be true during the Great Leap Forward and the Cultural Revolution public debate on economic issues subsided and instead revolutionary slogans took over. But in the early 1960s and again after the

implementation of economic reforms and open-door policies in early 1979, economic policymaking was embedded in a framework of contending ideas and suggestions on economic reform and development. In order to understand how China's continued search for economic growth and modernization may unfold, it is essential to carefully study the Chinese discourse and identify the various views on how to combine economic modernization and reform with continued growth in the context of a centralized political order.

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