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Armin Bohnet\*

# The "Socialist" Market Economy in a Communist System

## Taking Stock of China's Economic Reforms

*The Chinese model of a "socialist" market economy within a communist system is occasionally likened to the squaring of the circle. It is felt impossible to introduce a properly functioning market economy on a sustainable basis without abandoning the socialist pattern of ownership, and without jeopardizing the one-party system. The following article addresses, among other things, the tenability of this argument.*

In the past 20 years the People's Republic of China has been undergoing a transformation of its economic and social order which has involved a number of special features. The most remarkable of these are:

- the fact that the transition has passed off largely peacefully, being marred "only" by the crushing of the protests in Tian'anmen Square;
- the economic successes achieved, which have not only benefited the people living in China but have also turned the country into one of the world's great trading nations;
- the method of conducting experiments and moving the reform process ahead in small steps;
- the attempt to modernize the economy without democratizing the political system.

Thus China has transgressed a number of the fundamental rules that have been put forward and prescribed by the advocates of interdependent systems following the ideas of Walter Eucken. These basic principles include the incompatibility of socialism with a market economy, and of economic liberalism with political dictatorship. With that in mind, quite a considerable number of economists take the view that, sooner or later, China's approach to reform is doomed to failure.

So it becomes comprehensible that the Chinese model of a "Socialist" Market Economy within a

communist system is likened occasionally to the squaring of the circle. This comparison hints at the impossibility of introducing a properly functioning market economy on a sustainable basis without abandoning the socialist structure of ownership, and without jeopardizing the one-party system. The tenability of this critical argument is one of the points this article will seek to address.

The analysis will focus on four main areas. First of all, it will demonstrate how successful the Chinese economy has been by looking at some key economic data, and by making comparisons with selected transition countries in Central and Eastern Europe. It will continue by describing the most important features of the Chinese approach towards economic reform, which are also regarded as the roots of China's success. The paper will then contrast these remarkable successes with the numerous problems now confronting China's policy-makers, again pointing out the underlying causes. A number of conclusions will finally be drawn which might be applicable to transition processes in general. Among the points considered at this stage will be the part played by the political system, as both subject and object, in the reform process, and whether it is possible, or makes sense, to initially maintain the old political system without jeopardizing the fruits of economic reform.

### Indicators of Economic Success

The data used in this analysis have largely been obtained from official Chinese statistics. Because the system of national accounts used by western industrial nations did not supersede the concept of

\* University of Giessen, Germany. The article is based on a lecture given on 16th January 1997 at the University of Giessen's Centre for Regional Development Research.

national income normally used in socialist countries (that omits parts of the service sector) until the 1980s in China, the data are not always reliable or fully comparable. Moreover, due to the fact that the country's economy is simultaneously undergoing a system transition and rapid structural change, it is not easy to distinguish between real and nominal developments. Finally, it should be noted that the data used here are mainly averages covering the whole country. As such, they are incapable of reflecting the great differentials in living standards and economic development between urban and rural areas, between different regions and between different social groups. Nevertheless, the author still believes that the data show the correct tendency of underlying developments, allowing them to be used for both cross-sectional and longitudinal comparisons.

### National Income and Living Standards

Right from the outset of the reforms, China's real gross national product (GNP) has increased at two-digit rates virtually every year. If, as the US economist Paul Samuelson has done, one anticipates similarly high growth rates for the future, China's GNP will have overtaken that of the USA no later than in 2005.

The process of economic growth has simultaneously changed China's economic structure significantly. Whereas the country was still largely agrarian in the late 1970s, the industrial and service sectors have both become much more important in the meantime. Nevertheless, especially as far as the labour force is concerned agriculture still remains the predominant economic sector, and it will retain a great significance for China's overall economic development in the future.

China's economic boom is all the more impressive when one considers that, during the same period, many of the other transition countries suffered severe economic setbacks. This is illustrated by Figure 1, showing the development of China's gross domestic product (GDP) in comparison to those of Russia and four Central and Eastern European countries. Indeed, China's economic performance is quite able to bear comparison with Japan and the newly industrialized economies (NIEs), for here, too, its GDP growth rates are right in the forefront.

When it comes to combating inflation, China's performance has not been quite so superior to that of other transition countries. An especially remarkable feature is that the inflationary trend in China continued to rise substantially up to 1994, whereas accelerating

inflation had been halted somewhat earlier in most other transition countries. Price inflation peaked at 24.1% in 1994, but it has since been pushed down below the 10% mark.

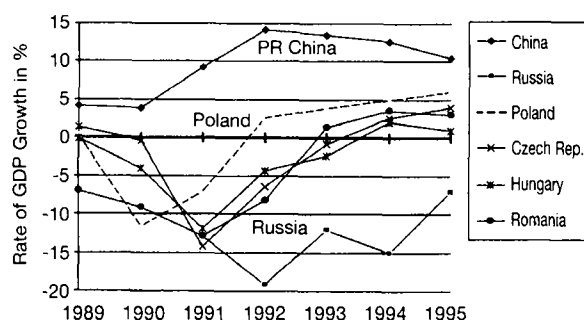
The evidence showing that the country's economic success is also benefiting the public at large includes data on the growth in real per capita incomes, on the development of living space, and on the amount of consumer durables families own.

It is noteworthy that both urban and rural income levels have increased markedly year after year – with the sole exception of 1989. A more detailed look shows, however, that the differential between urban and rural incomes has developed both ways. During the first five years of economic reform, up to 1984, rural incomes rose much more rapidly than those of city-dwellers did. In other words, the differential narrowed during this period. Later on, however, the opposite tendency set in, and the gap between urban and rural incomes has now widened once again.

One of the outcomes of these changing differentials is that there are considerable variations in the ownership of consumer durables (e.g., bicycles, refrigerators, colour TVs, washing machines) between urban and rural inhabitants. Although the rural population has been catching up quickly in the number of bicycles owned, it has fallen much further behind in absolute terms when it comes to the other consumer-durable items. So there are some key fields in which the reforms have not achieved any reduction in urban/rural differentials.

The only area in which the picture is the other way round is that of living space. People have

**Figure 1**  
**GDP Growth Rates Compared: China and selected Transition Countries**



Sources: Statistical Yearbook of China 1996, p. 42; Yue Bing: Der chinesische Weg zu einer Marktwirtschaft – Erforschung der Strategie der chinesischen Reformen. Ein Beitrag zur Theorie und Politik der Transformation der Wirtschaftsordnung, Giessen 1996, p. 177.

considerably more spacious accommodation in country districts than in the cities. However, the amenities in rural dwellings are usually relatively primitive.

### Foreign Trade and Capital Imports

Whereas China operated as a virtually autarkic state during the Cultural Revolution, with very limited foreign trade and economic contacts, the situation has changed drastically during the past 15 years. Two developments are particularly remarkable, namely the increase in foreign trade and the substantial inflow of capital goods and finance into China.

Figure 2 shows the impressive extent of these changes, with the volume of foreign trade having quintupled between 1983 and 1995. This has taken China up to 11th place among the world's exporters, and 12th place among importing countries. However, a still more important aspect is that, almost each year since 1990, the value of China's exports has exceeded that of its imports. Thus China has avoided one of the major pitfalls for developing countries in that it has not accumulated a debt mountain and saddled itself with the major economic burden resulting from debt service. Debt-service payments often exceed the attainable trade surplus, thus posing one of the main obstacles to satisfactory growth in the domestic economy.

Furthermore, it is remarkable that China has managed to move up to third place in the world as a recipient country for foreign direct investment in the 1985–1995 period, even in competition with the major industrial nations. To illustrate the point, Germany only attracted approximately one fifth of the volume of direct investment which flowed into China during that time.

Figure 2

#### China's Foreign Trade and Trade Dependence



Sources: Statistical Yearbook of China 1996, pp. 42 and 580; Statistical Yearbook of China 1993, pp. 31 and 633; own calculations.

The great importance of foreign capital for China is illustrated in Figure 3. The large contribution made by outside capital to China's total exports and imports is especially apparent.

These two developments taken together, i.e. an increasing trade surplus and the large inflow of financial capital, have allowed the People's Republic of China to join Japan and Germany, and indeed to overtake Taiwan, among the countries with the largest convertible currency reserves in the world. By the end of 1996, these had topped the \$100-billion mark, with a special government authority in Beijing managing a mix of dollars, yen, deutschmarks etc. according to modern portfolio-management methods.

### The Causes of China's Economic Boom

Seeing economic success on this scale, an outside observer naturally wonders where the causes lie, i.e. how the Chinese economy has managed to fly high for almost 20 years. Though the list is by no means complete, the author has sought to outline what he regards as the key reasons below.

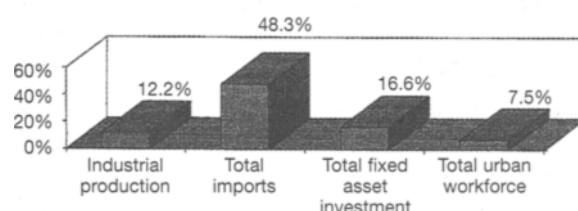
#### Step-by-Step Approach

In determining their reform strategy, China's politicians agreed to adopt the approach of "crossing the river by jumping from stone to stone" (Deng Xiaoping). Two fundamental decisions were vital to this strategy:

Firstly, reforms were not carried out all around the country on a comprehensive basis. Rather than applying a shock therapy, the Chinese method was one of step-by-step reforms. A classic example of the approach is the decision to start reforms in the agricultural sector alone (in the period 1978–1984), allowing the inefficient system of politically organized and controlled communes to be superseded by family businesses carrying a high level of their own

Figure 3

#### Part Played by Foreign Capital in the Chinese Economy



Source: China Nachrichten 3/96, p. 16.

responsibility, and giving those businesses the opportunity to sell part of their produce on a free market. The rush of new motivation thus triggered off generated a substantial increase in agricultural output, which in turn was a crucial prerequisite for the upturn in China's consumer and capital goods industries that followed later.

The second fundamental decision was the partial, cautious opening of China's economy to the world market. The establishment of four special economic zones in the first instance, while 14 ports were declared "open coastal cities", made it possible to ensure that the influence of world markets and modern technology from abroad were transferred to the Chinese economy in a controlled manner, and simultaneously to prevent any collapse of existing state-owned enterprises comparable to what happened in former East Germany. These "islands of growth", operating on a more or less capitalist basis, very soon created growth impulses for the surrounding regions, leading to the development of major economic centres of gravity over much of China's coastal territory. Today, the principle has been extended from the coastal regions to the island of Hainan in South China, five inland ports along the Yangtze, 13 border cities and 11 provincial towns in the interior; these regions offer special terms for foreign investment and for export/import operations. Table 1 provides a chronological review of China's open-door policy to date. The 9th five-year plan has announced further measures towards a more open economy by further liberalization.

### No Rapid Privatization

In contrast to the former socialist countries in Central and Eastern Europe, China has not privatized its state-run enterprises in the first instance. The ideological justification for this was the Marxian dogma of the superiority of socialist ownership of the means of production. Economically, the decision was a sensible one as the rapid privatization of government enterprises would not only have created an immense call on financial resources to modernize plant, facilities and production methods, but would also have triggered a steep increase in urban unemployment. Experience in East Germany provides a good illustration of these would-be consequences.

On the other hand, the reformers were well aware that, with state-run enterprises alone, China would not be capable of generating and sustaining the desired economic upswing. Therefore, single-person and collective enterprises were permitted from the early 1980s, and privately-run companies obtained a constitutional guarantee from 1988 onwards. In the following years, this so-called "non-state" sector was to become the real engine of the Chinese economy, and it has now overtaken the state-owned sector in terms of the value of its output. As Table 2 shows, government enterprises only contributed between 30% and 40% of output value in 1995, depending on the sector involved. So although government ownership of the means of production has still been formally retained, China is now in the process of shedding the socialist character of its economic

**Table 1**  
**Development of China's Open-Door Policy over Time**

Period	Reform stage	Location
1980	Special Economic Zones established in Shenzhen, Zhuhai, Shantou and Xiamen.	Guangdong and Fujian provinces in the south-east
1984	14 ports, including Shanghai and Tianjin, declared "open coastal cities".	Along the coastline from north to south
1985	Various towns in the Pearl River delta, the southern Fujian delta, Yangtze delta, Liaodong and Jiaodong peninsulas, and the district of Bohai are also opened up.	Close to the coast in the east and south-east
1988	The island of Hainan becomes an autonomous province and is declared a Special Economic Zone.	South China Sea
April 1990	The Shanghai district of Pudong is declared a special zone.	East coast
1992	Five ports along the Yangtze are declared "open cities".	Central China
June 1992	13 cities on China's international borders become "open cities".	North-east, north-west and south-west
August 1992	11 provincial towns are declared "open cities".	Interior

Sources: China's Economic Structure Reform, No. 10, 1992, p. 12; J. Wang, Y. Zhu (eds.): Handbuch der Reform des Wirtschaftssystems, Beijing 1987, p. 870.

**Table 2**  
**The Structure of Ownership in the People's**  
**Republic of China's Enterprises**

(expressed as % of gross output in each sector)

	1980	1995
Industrial enterprises		
• state-owned	76.0	34.0
• collective	23.5	36.6
• individual	0.0	12.9
• other	0.5	16.6
Construction enterprises		
• state-owned	63.7	39.90
• urban collective	23.5	20.60
• rural	17.3	39.05
Trading enterprises		
• state-owned	51.4	29.8
• collective	44.6	19.3
• individual	0.7	30.3
• other	3.2	20.5

Sources: Statistical Yearbook of China 1996, pp. 403, 457, 561; own calculations.

activity by virtue of the rapid growth of non-state enterprises, or in other words via a process of "cold" privatization.

If these trends are to be used as an explanation of China's economic success, it would also be fair to say that it was not brought by privatization per se, but rather by the introduction of competition due to the new forms of enterprise in the domestic economy and to the greater exposure to world markets as the economy was opened up. Not only did the new forms of enterprises and the imports flowing into the country plug some of the gaps in the range of products on offer, but they also provided better value for money than state enterprises did for traditional products, thus increasingly acting as their competitors. That placed state-enterprise managers and politicians under increasing pressure to do something about the situation. As far as possible enterprises have responded by improving their production techniques and the quality of their products. In cases in which that has not been sufficient, the state has had to help them out by making up their losses, or else it has had to close them down.

### Maintenance of Political Stability

Walter Eucken, who laid the intellectual foundations for the Social Market Economy, established the "constancy of economic policy" as one of the constitutive principles of a market economy; this principle applies similarly to transition countries and hence also to China. What it means in more specific terms is that if reforming processes are to be successfully modelled and carried out, the reforms

involved ought to be as free as possible of inner contradictions, and the economic actors they affect should have confidence in the stability of the measures taken. Furthermore, the reform process should follow a clear direction. The principle of "two steps forward, and one step back", which underlay Lenin's strategy during the period of the New Economic Policy in the 1920s, generates uncertainty and misgivings as to future developments, thus disrupting economic growth.

Policymakers in China have at least partially observed these rules regarding the constancy of economic policy and the predictability of the reform process. The constancy of the process has benefited from the fact that few changes have occurred in the structures of political decision-making in China. However much proponents of democracy will intuitively refuse to note any positive qualities in the upholding of a dictatorship, they nevertheless have to concede that the Beijing leadership's relative freedom from government reshuffles and shifting majorities allowed them to develop and pursue a concept for reform that was at least consistent in the medium term. How important this is can be seen by comparing the transition process in China with that in Russia and the other successor states to the Soviet Union, where continual power struggles for political leadership and uncoordinated leaps in the reform process have tended to annihilate rather than to nurture any faith in economically stable development.

### Underlying Economic Attitude of the People

Similar to the Germans who seized the opportunities of a new economic order after 1948, seeking to improve their own economic situation by their own initiative and hard work, so too we encounter people everywhere in China today who are willing to work hard to make money, are prepared to take risks, and want to try and put their own ideas into practice. For many years now, there has been a sense of new awakening in China, and it still shows no sign of ebbing. If bureaucratic or financial difficulties get in the way, people use their inventiveness, corruption, or a network of connections to forge their way through. That "Wild West" conditions will often predominate over orderly relations and a generally accepted ethics of the marketplace, will only surprise people who have had no personal experience of a period of upheaval. Yet there should be no mistake about this: had the economic reforms not been carried out, giving rise to a new set of frame conditions, this new economic attitude would never have become established, in

spite of – or even because of – the mentality of China's people.

Once again, the comparison with Russia suggests itself. In the author's opinion, Russia has neither been able to establish a clear, motivating institutional framework for economic activity nor do its people have the necessary sense of a new beginning with a pioneering spirit; consequently, the country is not able to get to grips with the tremendous economic problems it faces.<sup>1</sup>

## Unresolved Problems

The reports of China's economic successes ought not to be allowed to hide the fact that the country is by no means free of conflict. One source of current and likely future socio-economic problems, in the author's view, is the rapid growth of the Chinese economy, with the structural tensions and bottlenecks thus created. A further source of problems is the process of institutional change which the country's economic and social order has been going through for virtually 20 years and which has been accompanied by substantial shifts in the power and income structures among the public at large.

A first group of problems arise from the high rates of growth achieved, particularly by industry and the service sector, and the increasing geographical integration of the Chinese marketplace.

The problem most immediately apparent is the overloaded transport network. Despite the serious endeavours being made to reduce congestion in the big cities by building ring roads and by-passes and carrying out road-widening schemes, moving from place to place and transporting goods are both becoming increasingly chancy businesses. Corporate managers and government officials are finding it hardly possible, or at least very time-consuming, to keep their outside appointments. Similarly, the measures so far taken to expand the national road and rail networks have not been nearly sufficient to ensure that goods are carried swiftly and economically between the cities, let alone between regions. This is a situation which will not improve as long as the major rail routes continue to carry an endless stream of coal trains.

That brings us to the second problem, for the energy supply situation is also deficient. It is quite a regular occurrence for production to be disrupted because of energy shortages. The dominant fuel is still coal, which supplies 70% of the country's energy. Its energy-efficiency is low, and the resulting pollution levels are high. These problems would only be exacerbated by stepping up coal output. However,

the availability of alternative solutions is relatively limited. The oilfields in the north-east of the country (in Daqing province) are now gradually drying up, while the Xinjiang fields are only just beginning to come on stream, and extraction conditions there are relatively difficult. New hydroelectric power stations are now under construction, but the additional generating capacity they provide will not be nearly enough to meet demand. Though the construction of nuclear power stations would be a feasible alternative, this is also seen as a risky course to take, especially abroad.

For the reasons cited, the solution to the energy problem can only partly lie in tapping new primary energy sources or importing more fuel; much more important is the need to save on the use of energy. Because obsolete production techniques are still in widespread use, energy consumption in China is much higher than it is in neighbouring countries, let alone in a country such as Germany.

The belief that growth in the Chinese economy has been rather unbalanced is also borne out by statistics on growth in particular branches of the economy. These show that the provision of infrastructure in areas such as the steel industry, the road and rail transport networks and energy production are lagging considerably behind the average industrial growth rate. The one exception to this is in telecommunications which, with the support of foreign companies, has grown substantially in recent years.

Perhaps the most serious problem China faces is the rapid growth in environmental pollution. Most of the country's rivers and lakes are highly polluted, as indeed is the ground water in many places; 73% of the country's energy requirements are met by burning sulphurous coal; bicycles are increasingly being superseded by mopeds and cars; fertile agricultural land is being lost to industrial or residential construction, or is being eroded away. This list could easily be extended.

It is true, the prevention or elimination of pollution damage is among the priority items in the current 9th five-year plan. Yet, according to reliable estimates it would require 7%–15% of China's GDP to fulfil this

<sup>1</sup> The view is mainly expressed by Russian citizens that the majority of the country's own people are responsible for the parlous state it is in. Their mentality, so these voices say, is typified by a lack of will-power, cowardice and low self-esteem. This is said to be why they are prepared to stand by and see the law being blatantly broken, why they allow themselves to be intimidated, and why they prefer not to have bad politicians replaced, as they are afraid that any successors might be still hungrier for power, and might make still heavier demands upon them. (Kerstin Holm: Fröhliche Fassade, in: Frankfurter Allgemeine Zeitung, 21st December 1996, p. 29).

task, so it is reasonable to assume that the situation will grow still worse in the years ahead – a development which could affect the whole globe.

### Problems Resulting from the Reform Measures

The problems in the second group have arisen as a consequence of institutional change in general, and reforms of the economic system in particular. In other words, the very process of solving the problems generated by the old central planning system by making a transition to a new economic system has in turn created some new difficulties.

One such problem which is frequently cited is the increase in society's internal tensions. One dimension of these tensions is the steadily growing differential between rural and urban incomes. While this gap had narrowed somewhat during the first five years of economic reform (1979–1984) when the system of family responsibility was introduced to the rural economy, since that time the differential has taken a clear turn for the worse. By 1995, the income of an average city-dweller had risen to two-and-a-half times that of an average rural inhabitant. The main reasons for this widening gap have been above-average increases in the prices of fertilizer and other agricultural inputs relative to the prices obtained by selling produce. The increasing income disparity explains the huge stream of migrants from the land into the cities (unofficial figures place the number to date between 50 and 130 million people), with the associated problems arising as urban populations become more and more concentrated.

The income differentials from region to region within the agricultural economy are still greater. This is well illustrated by the figures in Table 3, showing an increase in the differential between agricultural incomes in the poorest province of Gansu and those of the richest (Shanghai) widening from 1:2.95 in 1978 to 1:4.75 in 1994.

**Table 3**  
**Trends in Agricultural Incomes**  
**in selected Provinces**

(net income in RMB yuan per person per annum)

	1978	1985	1995
1. China as a whole	133.60	397.60	1,221.00
2. Shanghai Province (richest)	290.00	805.90	3,436.60
3. Gansu Province (poorest)	98.40	255.20	723.70
4. Income differential (2 as a multiple of 3)	2.95	3.16	4.75

Source: Yue Bing: *Der chinesische Weg zu einer Marktwirtschaft – Erforschung der Strategie der chinesischen Reformen. Ein Beitrag zur Theorie und Politik der Transformation der Wirtschaftsordnungen*, Giessen 1996.

Given that the central government does not have adequate funds available for grants to the poor provinces at present, and that it has not so far shown any signs of wishing to carry out such a redistribution on a sufficient basis in future, while the rich coastal provinces are also refusing to make any substantial horizontal transfer payments, one cannot expect the income gap to close, at least in the short term. One of the reasons that this situation has the potential to cause severe conflicts is that the poorest regions also tend to be those with above-average populations of ethnic minorities. Tibet and Xinjiang are best known outside China in this respect, but these are not the only provinces by any means which suffer from ethnic conflict.

A further, related problem is that of the wide differentials within urban incomes. On the one hand, there are the self-employed and the employees in the non-state sector, and indeed also a number of wheeler-dealers with the air of the Mafia about them: people in all of these categories earn more than the average. On the other hand, there are the employees in state-owned enterprises and public servants, who earn less than average. No matter whether these people occupy posts in government enterprises, civil service departments, universities or research institutes, they are often so appallingly paid that they depend on second and even third jobs to earn a decent living. Accordingly, they will largely have lost any motivation to do a decent job at their official workplace. If one adds to this situation a propensity which people already have to make best use of their networks of contacts, there is a fertile breeding ground for bribery and corruption. These forms of behaviour cannot be prevented by high penalties alone. Without any doubt, the cases trumpeted in the press at regular intervals of officials neglecting their duties or of corrupt practices are really only the tip of the iceberg in China today. Corruption has always played quite an important part in the Chinese tradition, and it remains one of the really major problems in the new economic system. One measure, though not a sufficient one in itself, which could be taken to reduce the incidence of these misdemeanours would be to improve the pay of government officials and enhance the social recognition accorded to them.

On another level, there is the problem of the high losses made by China's state-owned enterprises. More than half of these enterprises are now operating at a deficit and are dependent on government support. One reason for that is the increasing



competition from private-sector and collective businesses to which they are exposed. However, another cause of these problems are the numerous welfare and community tasks these enterprises have to perform, as a legacy of the socialist past. As a prime example, their payrolls are invariably swollen due to the fact that there is hardly any public provision for unemployment pay, and the state has not yet permitted any mass dismissal of redundant employees. According to unofficial data, at least 20% of the employees in state-owned enterprises are unemployed in all but name. Other welfare facilities provided by these enterprises have also remained in operation: many of them still pay their own pensioners and operate their own hospitals, schools and nursery schools. All of this naturally costs a lot of money, making it difficult for the enterprises concerned to hold their own in competition with flexible collective or private enterprises.

A particular problem for the apparatus of the state in its more closely defined sense is the low level of government revenue. As a result of a process of erosion which has been going on for more than a decade, central and local government bodies now have to make do with budgeted revenue which barely reaches 11% of the gross domestic product (see Figure 4); that is substantially less than local and regional government alone have available to them in Germany, for example. Even after additional, non-budgeted sources of income are included, the government activity rate as a share of GDP is still only 15%. That makes China a good example of a country with public poverty in a Galbraithian sense. Another important characteristic of China's public finances is that the share of state revenue going to the central government declined from 47% in 1978 to 29% in

1995. This has led to a situation in which the central government cannot fully fund many of its important expenditure items any more. The bottlenecks arising are especially evident in the field of infrastructure, which has seen its share of total expenditure decline from 64% in 1978 to 42% in 1995. In the face of a budget deficit which has persisted and been growing for years, there is no remedy in sight for this malaise, at least in the short term.

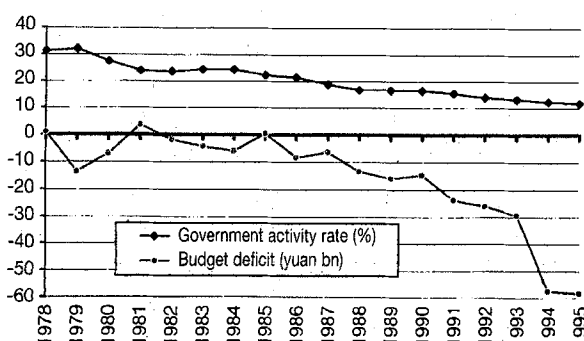
### Some Conclusions

The above descriptions of and explanations for the successful and unsuccessful developments in China's economy which have resulted from the reforms in the economic system and in the country's policy of economic development allow a number of conclusions to be drawn which, in the author's view, can be generalized. The following hypotheses can, he believes, be put forward on the basis of China's experience with its reform programme:

□ The more stable the political situation, the greater are the prospects of success in pushing ahead with the transition process. Frequent shifts in political majorities make it difficult to proceed consistently, thus preventing the necessary constancy of economic policy-making. Poland in the early years of transition and the countries from the former Soviet Union provide good examples of how an uncoordinated succession of repeatedly new programmes can sap the public's confidence in economic policy and in the policy-makers themselves.

□ It is easier to assert a change in the economic power structure if the economy as such is achieving positive growth. First of all, that allows some leeway to compensate those that have lost economic or political power by offering higher incomes: this is what happened in China with party functionaries in rural districts and small towns. Secondly, the resistance to reforms is very much smaller if they are coupled with an increase in average living standards for the general public. Here too, China serves as an example, for the rapid rise to riches achieved by certain regions and certain sections of society was justified and accepted along the lines that this would be just the beginning of a general improvement in living conditions, a situation which was certainly preferable to remaining in general poverty.<sup>2</sup>

**Figure 4**  
**Public Sector Share in GNP and**  
**Budget Deficit in China**



Sources: Statistical Yearbook of China 1991, p. 31; Statistical Yearbook of China 1996, pp. 42, 223.

<sup>2</sup> "Growing rich is not a crime. Our policies allow some people to attain prosperity more quickly. But wealth under socialism also means prosperity for everyone. By allowing a few people to run faster than others, we hope to reach our goal more quickly." Interview with Deng Xiaoping by Mike Wallace (translated from the German version in: Handelsblatt, 15th January 1997).

□ It is easier to enforce a reform if the most important groups within a country's society accept that reform. In China's case, these groups consist of peasant farmers, the working class, the bureaucrats (including Party cadres), and the intellectuals. The societal groups will be affected to differing degrees depending on the stage reached by the reforms. In China today, but also in the transition countries of Eastern Europe and Asia, the most substantial losers, both in terms of income and in terms of power, are or have been the lower to middle Party cadres, government officials, and economic controllers from the old planning apparatus. In a process which involves passing on new functions to previous holders of power while gradually moving to a new generation, China has succeeded in breaking down at least part of the resistance of those who had been favoured by the old system.

□ A reform ought not to be implemented any more quickly than a pace at which the new decision-makers in bureaucracies and business enterprises can find the formal legal framework they need, and have sufficient time to acquire new capabilities, so that they will indeed arrive at correct decisions. The importance of this soon became apparent, for example, in the former territory of East Germany, where a lack of experts in tax offices, ministries, local authorities and business enterprises combined with an unclear legal position on property ownership rights to create a whole series of obstacles and adverse developments in Germany's new federal states. The same deficiencies occurred on a still greater scale in Russia and the new Central Asian CIS countries. In China, the twin-track approach with the old and new systems operating side by side, and also the step-by-step application of the new one, meant the country avoided falling into the trap of destabilizing the old system without establishing, in good time, a new one which decision-makers have properly in their grasp.

□ Because economic transition is a long process, the results of the transition strategy need to be continually monitored to ensure a sufficient measure of success, and adjustments need to be made where and when necessary. To put it another way, there can be no such thing as a reform pattern which has been totally planned in advance, as the reform policy-makers are not omniscient as to how an economy will respond as a system. Such a totally planned approach would run completely counter to the claim made by the Nobel laureate von Hayek that competition, and hence also the establishment of and competition between efficient institutions, is a process of discovery which can only lead to the right solutions in gradual stages.

□ There is much controversy about the links between economic liberalization and political democratization. Adherents of the "ordoliberal" school who made a substantial contribution to the establishment of the Social Market Economy in Germany propound the theory that these systems are interdependent. Even if only economic freedoms are granted in the first instance, so their view goes, they would inevitably lead on to demands for political liberties too. From another angle, it is also suggested that a prerequisite for successful transition is the removal from power of the old system's decision-makers. That, they say, is the only way of preventing the "old guard" from pursuing a strategy of impeding the reforms.

There are also several arguments on the other side of the debate. The first of these is that a young democracy with few firm foundations is too weak to carry out a thoroughgoing economic reform which is not ridden with contradictions. The second is that proponents of democracy would not promote economically worthwhile reforms if they were liable to be placed at a disadvantage by this and if they feared their voters would turn their backs on them if income levels deteriorated. So, these arguments go, a more promising approach is to liberalize the economy first and then to democratize the political system.

There have been a number of examples in the past, and there are some in the present day, proving that a market economy can indeed grow up and prosper under a dictatorial political system. Spain and Chile in the western hemisphere, and Taiwan, Singapore, South Korea and indeed Japan in the eastern are cases in point. However, these examples also suggest that, as prosperity and economic freedom increase, politically authoritarian systems prove unable to uphold themselves for the long haul. As economic performance grows more successful, these political systems come under increasing pressure to reform, to the point of becoming democracies. In such cases, the adjustment process is certainly long-drawn-out; yet on the other hand, it does not call upon the population to make unduly large material sacrifices within a short space of time.

To return to the argument cited at the beginning of the article that China was squaring the circle, one might respond by stating that China has succeeded in acting as an example as to how an impure socialism, a market system and a one-party (communist) political dictatorship can actually co-exist. Nevertheless, in the long term both socialism and dictatorship will come under increasing pressure.