China: Economic Transformation Before and After 1989

Barry Naughton

Draft prepared for the conference "1989: Twenty Years After." University of California, Irvine. November 6-7, 2009.

The year 1989 in China marked the defeat of a group of reformists in the Communist Party leadership and shattered widespread expectations of continuing broad liberalization. In retrospect, 1989 marked the end of one era of cautiously managed economic reform. Economic reforms resumed in earnest around 1992, but they took on a much harsher form that exposed some social groups to major losses and widened inequality. The post-1989 model of economic reform was a model of concentrated power wielded more effectively. Thus, 1989 was important because it brought to the surface latent tensions over the direction of China's reform process, and led within a few years to the crystallization of a new reform model.

This paper primarily addresses the economic aspects of the change in China's reform and development model before and after 1989. I argue that while marketization characterizes both periods, there are important differences in the reform model that can be understood in terms of the priority given to government interests and the willingness to allow specific social groups to bear the costs of marketization. Before engaging that discussion, I begin with a more speculative section that describes the intellectual and international context within which these reform models developed. International events crucially shaped the way China's elites conceived of the reform process, in very different ways before and after 1989. Before 1989, China had an unusual degree of international space, or room for maneuver. After 1989, China frequently felt "crowded" by the United States. These different frameworks affected the calculations of policy-makers and correspond to the different models of economic reform that they adopted. Although China and the other Communist countries were going in opposite directions in 1989, they still exerted strong gravitational forces on each other. The 1989 events in China were shattering on their own. The *after-effects* of the 1989 turmoil were strongly conditioned by events in Russia and Eastern Europe. As a result, instead of being a temporary setback for reform, Tiananmen and 1989 ended up permanently altering China's reform trajectory.

Trading Places: The Intellectual Framework of Reforming Communism

1989 was the year when China definitively traded places with the Soviet Union. For a decade before 1989, China's leaders had maneuvered in a policy space carved out by Deng Xiaoping. This policy space was defined by the distance between the Soviet Union and the United States. In this space, Chinese elites could see themselves as more liberal, more pragmatic, and more realistic than Soviet elites, while still maintaining an obvious distance from the United States and its capitalist allies. Moreover, this position also meant that China was *favored,* in the sense that its form of socialism was seen in the US as being evidently superior to that of the Soviet Union. For the US, China was both a strategic partner (against the Soviet Union) and the pioneer of a version of socialism that would be more open and market-oriented, and might even evolve into a liberal society over a prolonged period of time. As a result, the US was willing to accord favorable policies to China, and the US-China relationship was not controversial in the US. The US, in turn, was not seen by China as a threat, and was plausibly seen as a protector against a lingering Soviet threat. This alignment of international and domestic policy "space" was quite favorable to the evolution of Chinese economy and society.

While it is a common error to ascribe too much of China's transformation to Deng Xiaoping personally, it is appropriate to attribute the creation of "room to maneuver" to Deng's personal efforts. Only Deng Xiaoping had sufficient political capital—due to his multivalent experience and patronage networks—to re-orient *both* the international and domestic policy environment. Deng Xiaoping was not an economic specialist, nor was he particularly self-confident about economic issues. However, he was extremely confident in his judgment about individuals and his mastery of strategic issues. During a two-year period from mid-1977 to mid-1979, Deng re-oriented nearly every aspect of China's policy *around* the key area of economic policy. Thus, Deng personally pushed to rehabilitate the education and science and technology sectors, most critically reinstating the fundamentally meritocratic nationwide college entrance examinations in 1977. Then, Deng aligned China with the United States, permitting China to "punish" Vietnam without fear of retaliation from the Soviet Union. Although the actual war against Vietnam was not a success, the strategic reassurance that Deng achieved emphatically was. Shortly thereafter, Deng proclaimed peace was essential for China's development, and subsequently declared that war was not inevitable and that peace was the main global trend, thus reversing a key late Maoist dictum (Deng 1980; 1985). This strategic reorientation paved the way for de-militarization of the Chinese economy, and the adoption of a strategy of economic reform. Deng thus created a framework for successful economic reforms, without contributing much to the specific content of economic reform. Tellingly, the single economic reform most closely associated with Deng personally were the Special Economic Zones, which had an important element of international reassurance and signaling, and which he championed but did not pioneer. In terms of actual economic policies, other leaders made more important direct contributions, but t hey were working in the space that Deng opened up.

China's strategic reorientation at the end of the 1970s released resources for the reform process and helped to shape—and ensure the success of—the experimental and tentative reforms. The 1980s strategic reorientation coincided with an intellectual framework, or worldview, which was also favorable for the evolution of economic policy. Many analysts of Chinese intellectual life have commented on the vast difference between the intellectual framework that prevailed in China during the 1980s and that which has prevailed since the 1990s, a contrast that virtually all writers on Chinese intellectual life have noted. During the 1980s, the positions advocated by virtually all important intellectual and cultural figures could be located along a continuum that stretched from the orthodox Marxist/Maoist to the liberal democratic. Revealingly, the word "conservative" was used unambiguously during this period to refer to orthodox Marxist or Maoist interpretations. Moreover, there was a broad consensus that China needed to move in the direction of liberalization. To be sure, there was no consensus either about the pace of liberalization or of the ultimate objective, and as the 1980s proceeded the consensus appeared increasingly wobbly. Nevertheless, there was a common framework broadly shared for envisioning China's position and movement. In the crucial year 1989 itself, because the demands of student protesters could be easily subsumed within this broad consensus, the demonstrators at Tiananmen commanded wide popular support in Beijing and other parts of China.

In addition, the "room for maneuver" opened up by Deng Xiaoping meant that issues of reform were not entangled with hot-button issues relating to patriotism, nationalism or regime survival. Reformists envisaged a future China that was richer, more diverse and more powerful, and they had both a critique of the economic stagnation caused by Maoism and a program to move toward greater strength and prosperity over the long term. Indeed, the most memorable occasions on which issues of patriotism were raised before 1989 involved the assertion that true patriotism should be more inclusive, raised by liberals. The writer Bai Hua questioned why the love that intellectuals had for their country was not requited (implicitly: by the Party). Although conservatives accused liberals of responsibility for "spiritual pollution," they could get no traction against the broader reformist program.

It was within this broad international and intellectual space that reformist leaders Hu Yaobang and Zhao Ziyang maneuvered against the natural resistance of an entrenched authoritarian regime. Courageous to begin with, each of them, in their own different way, gradually became committed to a more thorough and more profound vision of reform and opening. Even though their political positions were precarious, this was obvious only in retrospect, and they kept pushing, because they believed in what they were trying to accomplish and they saw no intrinsic structural obstacles to the goals they had set. In the end, however, the Revolutionary Elders—including Deng Xiaoping—held ultimate power, and when the Elders called a halt, the liberalization process screeched to a halt. Deng Xiaoping abandoned his own protégés and closed off the space he had opened up, and the reformists fell. External events did not, in any sense, "cause" this shift, which is more than adequately explained by the situation within China. But as it happened, the defeat of the reformists in China corresponded exactly with the triumph of liberalization in Eastern Europe, with the first elections, and ultimately with the dissolution of the Soviet Union and the collapse of Soviet communism. This was profoundly shocking to the Chinese leaders. It was not only unanticipated, it was virtually incomprehensible. When the coup was attempted against Gorbachev, the Chinese leadership not only welcomed the news; they seemed to experience something like relief. Their basic sense of how elites should behave when their power was threatened had finally been confirmed—only to collapse again as coup collapsed. Eventually the Chinese developed a complex, even convoluted, critique of the Soviet collapse that tried to knit together many of the criticisms they had made of the Soviet Union over the years.[1] But one is left with the impression that at the core of it is their absolute incomprehension at the behavior of an elite—a Communist Party elite—that failed to take minimal essential steps to protect their own regime. Of course, this sense was shared by other observers, including Richard Nixon (Simes 1999), as well as Suraska (1998) and Kotkin (2009). Ultimately, the Soviet collapse meant that China had to manage a much more thorough re-orientation of its domestic policy stance and develop a broader justification for its policy moves. As the shock of the Soviet collapse sank in, Chinese leaders found that all the landmarks that defined their policy space had disappeared.

In the intellectual realm, the simple spectrum between conservative and liberal collapsed. One of the first symptoms was the rise of public intellectuals who made their name as nationalists. Soon, a group of "new leftists" emerged as well. Defenders of economic reform split between those who became authoritarian free marketeers and social democrats. The simple coherence of the left-right spectrum shattered, and a variety of new hard-to-categorize positions emerged. It was no longer easy to locate an individual's views on the conservative-liberal spectrum. This splintering of positions put the Chinese Communist Party under much greater pressure to articulate the rationale for its continued rule. In the short run, of course, the collapse of the Soviet Union provided a convenient justification for regime continuity: "stability" was more important than anything, and was clearly superior to the Russian alternative. But over time, the regime had to come up with a stronger justification for its survival, which it found in an interesting mix of nationalism, elitism, economic performance, and the harmonious society, with leadership exercised by a Communist Party that had changed into a "governing Party." Whatever one thinks of this mix, it is very different from the comfortable consensus of the 1980s, when the Party was reforming and gradually loosening the bonds of an ideologically rigid past. Much as the Chinese Communist Party has continued to give lip service to the ideal of "reform," it has become in practice the upholder and defender of a new—or rather reformulated—orthodoxy. Like the Chinese critique of the Soviet Union, the new Chinese orthodoxy seems an odd mix of elements, growing by accretion. The Party declared at its most recent plenum (October 2009) that it upholds "socialism with Chinese characteristics; guided…with Deng Xiaoping Theory and the important thinking of the "Three Represents;" [and has] implemented and put into practice the scientific development concept in depth." This has some meaning, but it is cobbled together from heterogeneous elements and the seams and stresses are quite evident.

Changes in the international environment contributed strongly to the sense of predicament that confronted the Chinese Communist Party. China was able to ride out the initial

[1] This Chinese critique has not, to the best of my knowledge, been analysed in the English language literature. Shambaugh (2008) provides an excellent description of the multi-dimensional response within the Chinese Communist Party to the Soviet collapse, but he does not undertake the thankless task is disentangling the ideological components of the Chinese critique.

wave of revulsion over the Tiananmen massacres, and avoid major trade embargoes or international ostracism. But from 1989 onward, the friction between China and the established powers never disappeared. From being the unthreatening variant of Communism, China has become the great anachronism, the sole surviving successful country that is still ruled by an authoritarian government, and a Communist Party to boot. Moreover, something very unexpected happened in the global economy in the 1980s: the United States began to grow slightly more rapidly than the world economy as a whole. Between the early 1980s and about 2000, the US's share of the world economy stabilized, and even increased slightly. This was a sharp contrast from the experience of the world economy in the 1950s and 1960s. It was also against what economists normally predict ("convergence" which implies catch-up of well-positioned follower economies); and very different from expectations at the end of the 1980s. Indeed, a common saying at the time was "the Cold War is over, and Japan and Germany have won." Such a view was of course focused on economics, and stressed the difference between economic outcomes (seen to favor Japan and Germany) versus ideological outcomes (where American triumphalism reigned). In any case, it did not happen. Japan drifted into its own decade of stagnation, while Germany took on burdens in the transition and reunification process that slowed its growth and diminished its international impact for a decade or more. The numbers two, three and four global strategic powers either collapsed (the Soviet Union) or underwent dramatic slowdown (Japan and Germany). The process seems to have been very different and domestically driven in each case, but the combined outcome of the three was unambiguous: the dominance of the number one power, the US, was bolstered.

The rejuvenation of US hegemony was not something Chinese leaders expected, and not something they welcomed. From the Chinese perspective, the failure to move toward multipolarity in the 1990s meant that China could not rely on having international "space" in which to maneuver. On the contrary, Chinese policy-makers have since constantly felt "crowded" by a US which is wary of China's rise. In the security realm, China perceives the US as clinging to its predominant power. Unlike policy-makers in Gorbachev's and Yeltsin's Russia, the US seems to the Chinese to be steadily focused on a version of its own national interest. This puts greater pressure on China, which since 1989, as part of its model of economic reform and development, has had to find resources to provide for security. During the 1990s, economic security became a legitimate topic for discussion in China. These changes frame the changes in economic strategy that mark the pre- and post-1989 eras.

Economic Transition Before 1989

It is not immediately obvious that 1989 was an important dividing point in China's economic transition policy. Before 1989, China was pursuing an incremental transition to a market economy under the tutelage of the Communist Party, and the same is true after 1989.

However, deeper probing reveals substantial differences between the two eras. After the retreat from reform in the years 1989-1991, reforms restarted with a very different configuration. (Deng Xiaoping's "southern tour" in early 1992—in which he symbolically reaffirmed economic reform by visiting the Special Economic Zones—is conventionally taken as the kick-off point of renewed reform.) The difference in reform strategy has long been noted by students of the Chinese economy, but they have tended to analyze it narrowly as primarily a question of technical choice of an effective reform strategy. Moreover, seen from this standpoint, the crucial point of strategic inflection comes in 1993-94 (Naughton 2001; 2007; Qian and Wu 2003). Thus, 1980s reform has been characterized as de-centralizing, dual track, and making extensive use of particularistic bargains and contracting. These characteristics are contrasted with post-1993 reforms which were re-centralizing, stressed market unification and promoted reforms of ownership and improved regulation. This emphasis deflects attention from Tiananmen and the events of 1989. Moreover, there are important differences in the structure of political power at the summit of the Chinese system that are only indirectly related to Tiananmen but which change dramatically around 1993 (Naughton 2008). In the 1980s, power was fragmented and distributed among a large number of elders and second generation leaders, many of whom had a veto over some aspect of policy. As theory predicts, such a configuration was associated with low decisiveness, but relatively stable policy positions. Later, and especially after 1993, power at the top passed from the revolutionary elders into a more "ordinary" centralized hierarchical Communist system, with far more decisive policy-making and concentrated power (Cf. Tsebelis 2002). This structural explanation still has a great deal of explanatory power, but here I link the policy changes more closely to the impact of 1989, which was under-emphasized before. In a recent stimulating work, Huang Yasheng (2008) regards the 1980s as a kind of golden age, in which rural reform and private entrepreneurship were the focus of reform, and the keys to a "good capitalism," but which were discarded for a state-sponsored "bad capitalism" in the 1990s. Huang's overall picture is over-simplified, and subject to a certain amount of myth-making, but it does illuminate some of the differences between the periods, and I support some of Huang's findings here.

Utilizing "Economic Space" to Reform the Economy in the 1980s

In the early stages of economic reform, difficult choices must be made in order to make some people better off. In the long run, increased efficiency and economic growth can compensate supporters of reform and solidify reform coalitions, but these gains take time to materialize. At the very beginning of economic reform at the end of 1978, crucial economic choices were made that shaped all of the 1980s. A central role in making these choices was played by party elder Chen Yun. In many respects, Chen was conservative. However, Chen was also an economics specialist who strongly supported the idea that the economy needed "space." At the core of the initial shift in policy, in December 19978, was the conviction that the rural economy needed "room to breathe." Development plans needed to be less ambitious and less urgent, so that consumption could recover and households could be reassured that they could keep the fruits of their labors. Agricultural procurement prices were lowered, compulsory procurement quotas were reduced, and grain imports dramatically increased. Production was shifted into labor-intensive sectors that increased the supply of consumption goods.

Where did the resources come from to increase consumption and support a more "relaxed" growth strategy? Chen Yun took the lead in chopping back the overly-ambitious 10-Year Plan and "Leap Outward" promoted by Hua Guofeng. Under Chen Yun's watch, contracts to purchase foreign factories were cancelled, and domestic investment was reduced sharply, and space was opened up for greater consumption and for the growth of new organizational forms. This policy called for a Three Year "Readjustment," beginning in January 1979 (intentionally echoing the policy and slogan from 1961-62, when Chen Yun had presided over the recovery of the economy after the Great Leap Forward disaster). Chen Yun's commitment to this approach to the macro-economy was so strong that when macroeconomic imbalances re-emerged at the end of 1980, he insisted that China push the restart button on the three year Readjustment period, declaring:

> Some might say, "This will delay us three years." No worry. China's economic construction has already been delayed more than a hundred years, since the Opium War. And besides, it's not really a delay: if we don't readjust, it [economic construction] will end up taking much longer (Chen Yun 1995: 282 [December 16, 1980]).

This became national policy and was sustained through the 1980s.

Deng Xiaoping himself did not agree with Chen Yun's position, but he accepted it. Deng had previously supported the grandiose 10-Year Plan, and he continued to support a more rapid investment and growth push. Deng and his protégé and ally Hu Yaobao (nominally the Party Secretary) pushed to have the target of quadrupling GDP by the year 2000 written into the Report of the 12th Party Congress in 1982. Don't forget, he was saying, our ultimate objective is still to develop into a strong and modern country. But this was a kind of pendant to the moderate macroeconomic policies that were actually being followed in the short term. Deng created space internationally and politically, while Chen created space economically.

Day to day management of the economy passed from Chen Yun to Zhao Ziyang, the Premier, between 1979 and 1982. Zhao was a next generation protégé of Deng Xiaoping. Zhao pushed much harder and searched more systematically for institutional innovations than Chen Yun would ever have done. But Zhao also supported Chen Yun's desire to maintain a relatively relaxed macroeconomic environment. He maneuvered within tight constraints to combine Chen Yun's moderate macroeconomic policy with Deng Xiaoping's open-minded approach to institutional reform.[2] The successful 1980s reform package emerged from Zhao's maneuvering. Chen Yun and other more conservative elders signed off on Zhao's quest, because they were re-assured that his vision of economic reform was consistent with relative macroeconomic stability and a cautious approach to the economy. Zhao Ziyang solicited views on reform strategies from outside the government bureaucracy, and effectively sidelined the bureaucratic Planning Commission, further reducing the influence of a voice that systematically advocated more investment and faster growth.

This "go slow" policy orientation can be discerned in simple quantitative indicators. Figure 1 shows resource outlays for four categories of expenditure that we would expect to be large in a techno-nationalist government-dominated growth-oriented polity. Budgetary defense and scientific research and development (R&D) expenditure both came down dramatically during the 1980s from their planned economy highs. Investment in infrastructure was modest—Figure 1 shows that investment in electricity generation and transport and telecom were each at modest levels around 2% of GDP through the 1980s. Figure 1 shows that these investment levels were low compared to what was later achieved in China. They are also low relative to international best practice: the World Bank has suggested a "rule of thumb" that physical infrastructure investment must be at least 6-8% of GDP in order to support sustained rapid economic growth. China in the 1980s was well below this recommended level. This relatively modest investment effort allowed China to maintain a relatively relaxed macroeconomic environment. The willingness to postpone public goods investment was also evident at the local level during rural reform, where expenditures for rural education, health and irrigation, which had been funded by the collectives, were allowed to fall. More generally, as Figure 2 shows, the relative weight of the government budget as a whole declined dramatically through the 1980s (although in this case the decline continues into the middle of the 1990s, due to the time lags involved in creating effective fiscal mechanisms). By releasing its claim on resources, the government opened up space for reform.

The Pace of Reform: Bauer-Kornai Cycles

Given this basic orientation to the reform process, the concrete pace of reform was decided by the degree of macroeconomic imbalance in any given year. There were dangerous inflationary episodes in 1980, 1985 and 1988, shown in Figure 3 (quarterly data start in 1983, so the 1980 cycle is not shown). Cumulative inflation throughout the entire 1980s was modest, compared with the extreme inflation in the Soviet Union and much of Eastern Europe. Relaxation of price controls in the presence of highly distorted prices inevitably produces inflation, and China's cautious macroeconomic policies can, in this context, be seen to have kept inflation largely under control over the long term.

[2] This was already the best interpretation of policy dynamics during the 1980s, but it has been strongly confirmed by the publication of Zhao Ziyang's memoirs (2009), especially pp. 91-113.

In the short term, however, inflation was a recurrent and critical problem. We see clear evidence of a policy-related cycle in the inflation data. Policy de-centralizations typically led to surges in investment demand from localities and enterprises, upsetting the macroeconomic stability and leading to inflation. These clearly fit the pattern of so-called "Bauer-Kornai cycles," first described in the Hungarian context by Janos Kornai and his colleague Tamas Bauer. It is not at all coincidental that Kornai first developed his seminal concepts of the soft budget constraint in the context of Hungarian reform experience of the 1950s and 1960s. As reform-induced decentralization spread, macroeconomic imbalances increased, much to the surprise of reformers who had expected a movement away from Stalinist imbalances. Under the conditions prevailing in Eastern Europe at that time, the desire to control these imbalances led planners to smother reforms in their crib. The economic dynamic in China was the same, but the outcome was different for political reasons. While short-run retrenchments were unavoidable, Zhao Ziyang was eager to get the reform process going again as soon imbalances were under control. The influence of "reformers" (Deng and Hu) and "conservatives" (Chen) waxed and waned along with this macroeconomic cycle (Zhou 1993). With Zhao's hand on most of the policy levers, the reform process kept moving forward. The inflationary cycle of 1988-89 could probably have been mastered as well, but the muddle of Tiananmen, interacting with deadly political infighting, spelled the end of the reformist ascendancy.

Reform without Losers

As is often said, Chinese reform proceeded incrementally and without a blueprint. But given the political realities of fragmented power at the top, combined with a willingness to accommodate the resource needs of economic reform, the reform policies that emerged were quite distinctive. It is more surprising that such reforms were economically successful, than that they could be sustained politically for a decade.[3] The resulting pattern of policy has been dubbed "reform without losers." (Lau, Qian and Roland 2001). Of course, there were winners from reform: in the early stage, farmers, especially those in the economic orbit of large cities, founders of new businesses, and entrepreneurial local officials. The key feature of the 1980s was the absence of losers. Few state-owned enterprises went bankrupt, even though SOE profitability eroded steadily. Scarcely any worker in state-owned firms lost their jobs. Indeed, the single most characteristic institution of this period was the "dual track," whereby firms continued to meet plans and buy and sell at planned prices, while also selling above-plan output at market prices. Such a system was a convenient way to grandfather in virtually every SOE with a contract ("plan") customized to its unique conditions and past trajectory.

---

[3] I have addressed in earlier work the detailed component policies of the 1980s reform era, and the question of why they were surprisingly successful. I do not discuss these issues further in this paper. Interested readers can consult McMillan and Naughton (1993); Naughton (1995; 2001; 2007).

Most domestic markets were protected against foreign competition, and new foreign invested enterprises generally exported their output. Budget constraints remained soft, some productivity gains were deferred and of course, as shown earlier, government revenues steadily eroded. But these costs purchased precious benefits: the economy grew and became much more flexible; a whole light industrial sector grew up that could provide consumer goods for China's vast population and eventually for export; a healthy ecology of large, medium and small firms emerged. Most important, markets emerged and began to play a crucial role in allocating goods. A market economy began to grow up through the interstices of the bureaucratic economy.

The Breakdown

The political and economic model of the 1980s collapsed in 1989. The cause of the collapse can be easily traced to the factors discussed in previous sections: the inflection point of a Bauer-Kornai cycle in early 1989 increased dissatisfaction among the population. Inflation was still high, while contractionary policies created dislocation. (There were some short-term losers at this time). Zhao Ziyang's willingness to accommodate the demonstrators created anxiety among the Revolutionary Elders, and made Zhao vulnerable to a vicious attack from reactionaries. In the wake of Zhao's fall, and with the accelerating collapse of the Soviet empire in the background, conservatives rolled out a set of complaints against Zhao and the reformers that could orient their new policies. Zhao personally had threatened the stability of the Communist regime in pursuit of his own personal faction, they argued. He had not shown adequate respect for the Godfathers. These criticisms can be regarded as ordinary by-products of political infighting. On the economic front, Zhao found he had lost the support of conservatives such as Chen Yun, because he had failed to master the inflationary cycle of 1988-89. At the same time, reformists were uncertain what the next step should be. In this context, economic conservatives argued that the apparent gains of the economy were illusory, and that the failure to invest in core industries and public infrastructure meant that the economy was on extremely shaky ground. They were wrong, but their argument was plausible, and they drove the economy away from economic reform for three years, as they tried to get back to basics (CCP 1989; Fewsmith 1997). Looming over this policy shift was the sense that the world had changed dramatically. China no longer had much space for maneuver, and regime survival was at stake.

The Reform Model After 1989

Economic reforms restarted in earnest in late 1993, in the midst of China's last pure Bauer-Kornai cycle. The policy focus of reforms differed dramatically from those of the 1980s. Decentralization, particularistic contracting, and the "dual track" were set aside, and the central plan was discarded at the end of 1993, with a whimper rather than a bang. The focus of institutional reforms shifted to the effort to create a level playing field for markets and an adequate institutional basis for corporatization and regulated competition. Equally prominent, however, was the new priority given to state interests. Figure 2 has already shown that budgetary revenues displayed a remarkable trend reversal after reaching a low point of 10.8% of GDP in 1995. After this 1995 inflexion point, budgetary revenues climbed as a percentage of GDP every single year through 2008, when they reached 20.5% of GDP. Clearly some very different processes were at work compared to those in the 1980s.

Removing the Barriers to Marketization: Reform with Losers

After 1993, the Chinese government cautiously but steadily removed the barriers to marketization and let uncompetitive firms and workers fail. We can most readily see this in three areas:

1. Public enterprises were exposed to much more open competition and harder budget constraints on the financing side. This change coincided with a wave of privatization, beginning in the countryside with the "township and village enterprises" and culminated in the early part of the 2000s with the privatization or closure of most of the smaller state-owned enterprises (SOEs). Figure 4 shows that the workforce of SOEs, including all corporations in which the government has a controlling stake, declined from 76 million in 1993 to just under 43 million by year-end 2005. Over a little more than a decade, 33 million workers lost their jobs, mainly to early retirement or lay-offs. Banks wrote off trillions of RMB in loans to failing SOEs, and began the arduous shift to a commercial banking system, making decisions based on risk and return (at least until 2009).

2. Market opening culminated in World Trade Organization membership in 2001. WTO membership not only implied a much greater openness to imports, it also generally allowed foreign-invested enterprises to sell freely on the Chinese domestic market.

3. Barriers to rural-to-urban migration were steadily lowered. Formal and informal discrimination, segmented labor markets, and "undocumented" status are persistent problems. Still, the flow of (primarily) young workers out of agriculture and into urban occupations has continued and accelerated through the post-1989 period. By the second quarter of 2009, an estimated 150 million rural people were working outside their home counties.

This reform orientation dramatically changed the processes at work in determining income and social outcomes. Low skilled, particularly older, urban workers were particularly hard hit. They faced new competition from rural migrants, and their job security suddenly evaporated. At the same time, rapid urban growth raised income for high skilled, younger workers and those with special access to opportunity. Overall income inequality increased dramatically, and some groups lost in absolute terms.

Government as the Priority Claimant

One group that fared well in the new policy environment was government. An expanded tax base put government on a firm financial footing. An influx of talented and well-educated personnel vastly upgraded the quality of government. The massive downsizing of the state enterprise sector benefited government because the loss-making firms were disproportionately those that were shut down or sold off. Most crucially, the largest and most profitable firms were maintained under government control. Generally speaking, this corresponded to a distinction between firms in competitive sectors and those in natural monopoly or strategic sectors. In competitive sectors, the vast majority of firms were privatized, or simply could not compete in the new market environment. However, in sectors with market barriers, a different pattern was created. State ownership was retained, but monopolies were converted into oligopolies, with two or three large state firms competing. Better institutions of corporate governance were put in place. In 2003, a central government "ownership agency" was created to exercise government's ownership powers. The State Asset Supervision and Administration Commission (SASAC) assumed ownership of 196 of the largest non-financial firms. Following central SASAC's creation, similar agencies were created at the local government level. SASAC followed an agenda of professionalization, specialization, and creation of internationally competitive firms that could eventually become "national champions."

As Chinese economic policy has succeeded in many respects, the role of the restructured state sector has emerged as an area of continued controversy, replete with unanticipated consequences. In the first place, as Figures 2 and 4 show, China's state sector has stabilized and become healthier in recent years. After reaching a low point in 1996-98, state sector profitability climbed strongly during the 2000s. More tellingly, after dramatic cuts around the turn of the century, the state sector labor force appears to have stabilized around 2004-5. Figure 5 presents a closer look at the state sector as of the end of 2007. This shows that the Chinese state sector is now composed of about two equal components, one central and one local. This is a huge change. Since the early 1970s, China's state sector has been predominantly local, and composed of many medium-sized firms. Soviet-style gigantism was never the pattern of the Chinese state sector. But now most of the local state sector is gone, replaced by something quite different, a Chinese-style capitalism, based on tight links between entrepreneurs and local government officials. The central state sector, on the other hand, is not gone at all. Indeed, at Tables 1 and 2 show, over the past five years, employment in the central state sector has increased significantly, while employment in the local state sector has declined. Both central and local sectors have become significantly more capital intensive, but the central share of total capital has increased substantially. This state sector, dominated by large, well-capitalized central government corporations is a new phenomenon in China, not seen since at least the 1950s.

At the same time, Figure 5 shows that the apparent rationality of central SASAC's empire is partly an illusion. In theory, central SASAC today "owns" only 138 companies, after consolidating and merging its initial 196. But in practice today's companies preside over a staggering 16,870 subsidiaries of all kinds. These are sprawling corporate empires with interests in wide-ranging areas. SASAC tries to push top-level firms to specialize in their core competences. SASAC leader Li Rongrong frequently echoes General Electric CEO Jack Welch's dictum that each subsidiary should be among the top three in its industry, or else should be disbanded. Many SASAC firms have indeed developed impressive capabilities in their key areas of operation. But the aggregate numbers in Figure 5 show that this is by no means the whole story. The state empire in fact consists of large web of patronage and business opportunity which is only imperfectly tracked at the top.

Intertwined with this business empire is the power of the Communist Party. The Chinese Communist Party, like those in all other Communist states, exercises the nomenklatura authority.[4] Today, the Communist Party remains deeply engaged in the disposition of firms and the appointment of managers. When enterprises established Boards of Directors as part of the new Company Law, Communist Party Committees, as part of their nomenklatura authority, appointed the Board Members that represented the public owner. This has actually given the Communist Party a more direct stake in state enterprise management than it had before. Of course, this change in the way Communist Party power was exercised changed the Communist Party as well. It became more professional and interested in efficiency; and it became an even more important interest group, acting in its own interest and advocating the public interest as perceived by Communist Party members.

The evolution of the Communist Party's role can be traced back to 1989. Before 1989, most of the stress of political reform was on redefining and reducing the direct Communist Party role in the economy. This approach was widely rethought after Tiananmen and the collapse of the Soviet Union. Perhaps the most radical suggestion to this question came in the 1991 "Princeling Manifesto," said to have been written by three young Communist Party insiders, the maverick conservative intellectual He Xin, and the two "princelings" Chen Yuan (son of Chen Yun) and Deng Yingtao (son of Deng Liqun). Their so-called "Princeling Manifesto," was an unusually wide-ranging and provocative document that made a breathtaking suggestion: They argued that just as it was axiomatic that "the Party controls the gun," so it should be accepted that "the Party controls the assets." By giving the Communist Party direct ownership of society's wealth, the question of who was responsible for public assets would be resolved; and the conflicting regulatory and protectionist impulses of varying levels of government would be counter-balanced by a vigorous advocate for asset maximization. Direct party management of the economy would be re-instated, but the Party's perspective would become that of the owners of capital (Theory Group 1991). Taken literally, this suggestion went nowhere. The Communist

[4] For a brief period in 1988-89, Party Committees in enterprises and government ministries were removed from their positions of authority, and made clearly subordinate to factory managers and government bureaucracy officials. Obviously, this measure did not survive the post-Tiananmen restoration.

Party of China never began to accumulate assets in its own name in the way that, for example, the Nationalist Party (Guomindang) did in Taiwan. But in a broader sense, the Princeling suggestions pointed the way to the system's future evolution. Today, the Communist Party does indeed manage the largest, most concentrated groupings of capital in China.

Conclusion

The political crisis of June 1989 was the catalyst for a shift in the overall pattern of Chinese economic transition. In both political and economic terms, the crisis gave urgency and legitimacy among the ruling elite to a model of concentrated power wielded more effectively. As a result, the next stages of marketization were combined with a stronger role for the state, and a regime more capable of mobilizing resources for economic development and national security. Before 1989, China's leaders were willing to subordinate other national interests to the quest for a viable economic reform model, and thus a better economy and society. After Tiananmen, while reformers still pursued a vision of a transformed economy, that vision was linked to, and often subordinated to, strengthened, stabilized and more effective government power. Inevitably, "government power" also meant "Party power," although the nature of that Party may perhaps be unrecognizable to one familiar with a Soviet-style Party under a socialist economy.

A remarkable fact is that economic policy was primarily successful during both of these contrasting periods. During the first period, Zhao Ziyang maneuvered through a treacherous political environment to loosen the bonds of the planned economy and bring market forces to life. Although he failed politically, he succeeded economically. During the second period, a succession of leaders has maneuvered to strengthen the state and shore up political control while also pushing the economy toward a higher level of economic functioning. In this, they have also been primarily successful. Indeed, the high point of this model may have come in 2008-2009. In response to the global financial crisis, the Chinese government and Communist Party rapidly implemented a Chinese stimulus package that produced the first "green shoots" in the struggling world economy (Naughton 2009). The Chinese Communist Party Central Committee, meeting in conjunction with the State Council, decreed the stimulus, and used the hierarchical Communist Party apparatus to convey the urgency of action to the grass roots levels. Literally within weeks, local governments down to the county level began rolling out "shovel ready" investment projects that were suddenly eligible for funding. The model of concentrated power, decisively wielded, had economic benefits that rippled through the world economy. Economic success and concentrated political power has allowed China to muscle into a crowded and competitive global economic environment. Whether it will be compatible with the continued evolution and diversification of Chinese society remains to be seen.

References

CCP (1989). Chinese Communist Party Central Committee, "Zhonggong zhongyang guanyu jinyibu zhili zhengdun he Shenhua gaige de jueding (zhaiyao). [Abstract of Party Central Decision on Further Rectifying while Deepening Reform]," November 9, 1989. In *Zhongguo Jingji Nianjian 1990*. Beijing: Zhongguo Jingji, 1990. Pp. I6-I16.

Chen Yun (1995). *Chen Yun Wenxuan [Selected Works of Chen Yun], Vol. 3.* Beijing: Renmin.

Deng Xiaoping (1980). "The Present Situation," January 16, 1980. *Selected Works of Deng Xiaoping*. Beijing: Xinhua.

Deng Xiaoping (1984-85). *Fundamental Issues in Present-Day China*. Beijing: Foreign Languages Press, 1988.

Fewsmith, Joseph. 1997. "Reaction, Resurgence, and Succession: Chinese Politics Since Tiananmen," in *The Politics of China: Second Edition, The Eras of Mao and Deng*. Roderick MacFarquhar, ed. Cambridge and New York: Cambridge University Press, pp. 472–532

Huang, Yasheng (2008). *Capitalism with Chinese Characteristics: Entrepreneurship and the State.* New York: Cambridge University Press.

Kotkin, Stephen (2009). *Uncivil Society: 1989 and the Implosion of the Communist Establishment*. New York: Modern Library.

Lau, Lawrence J., Yingyi Qian, and Gérard Roland. 2001. "Reform without Losers: An Interpretation of China's Dual-Track Approach to Reforms." *Journal of Political Economy*. 108: 1, pp. 120-143.

McMillan, John and Barry Naughton (1992). "How to Reform a Planned Economy: Lessons from China." *Oxford Review of Economic Policy*, 8:1 (Spring).

Naughton, Barry (1995). *Growing Out of the Plan: Chinese Economic Reform, 1978-1993*, New York: Cambridge University Press.

Naughton, Barry (2001). "Changing Horses in Midstream? The Challenge of Explaining Changing Political Economy Regimes in China," in Jaushieh Joseph Wu, ed., *China Rising: Implications of Economic and Military Growth in the PRC*. Taipei: Institute of International Relations, National Chengchi University. Pp. 37-65.

Naughton, Barry (2007).*The Chinese Economy: Transitions and Growth*. Cambridge, Massachusetts: MIT Press.

Naughton, Barry (2008). "A Political Economy of China's Economic Transition," Chapter 4 of Loren Brandt and Thomas Rawski, eds., *China's Great Economic Transformation*. New York: Cambridge University Press. Pp. 91-135.

Naughton, Barry (2009). "Understanding the Chinese Stimulus Package," *China Leadership Monitor.* Issue 28, Spring 2009.

Qian,Yingyi and Jinglian Wu. 2003. "When Will China Complete Its Transition to the Market?" in *How Far Across the River? Chinese Policy Reform at the Millennium*. Nicholas Hope, Dennis Yang, and Mu Yang Li, eds. Stanford: Stanford University Press, 2003.

Shambaugh, David (2008), *China's Communist Party: Atrophy and Adaptation*. Washington, D.C.: Woodrow Wilson Center Press.

Simes, Dmitri (1999). *After the Collapse: Russia Seeks Its Place as A Great Power*. New York: Simon and Schuster. P. 20.

Suraska, Wisla. 1998. *How the Soviet Union Disappeared: An Essay on the Causes of Dissolution*. Durham: Duke University Press.

"Theory Group" (1991) Zhongguo Qingnianbao Sixiang Lilunbu [Theory Group of China Youth Daily], "Sulian jubianzhihou Zhongguo de xianshi yingdui yu Zhanlue Xuanze [The practical challenges and strategic choices China faces in the wake of the Soviet collapse]." Processed. September 9, 1991.

Tsebelis, George. 2002. *Veto Players: How Political Institutions Work*. New Jersey: Princeton University Press.

Zhao Ziyang (2009). *Prisoner of the State: The Secret Journal of Premier Zhao Ziyang*. New York: Simon & Schuster.

Zhou, Xiaochuan. 1993. "Privatization versus a Minimum Reform Package." *China Economic Review*. 4(1), pp. 65–74.

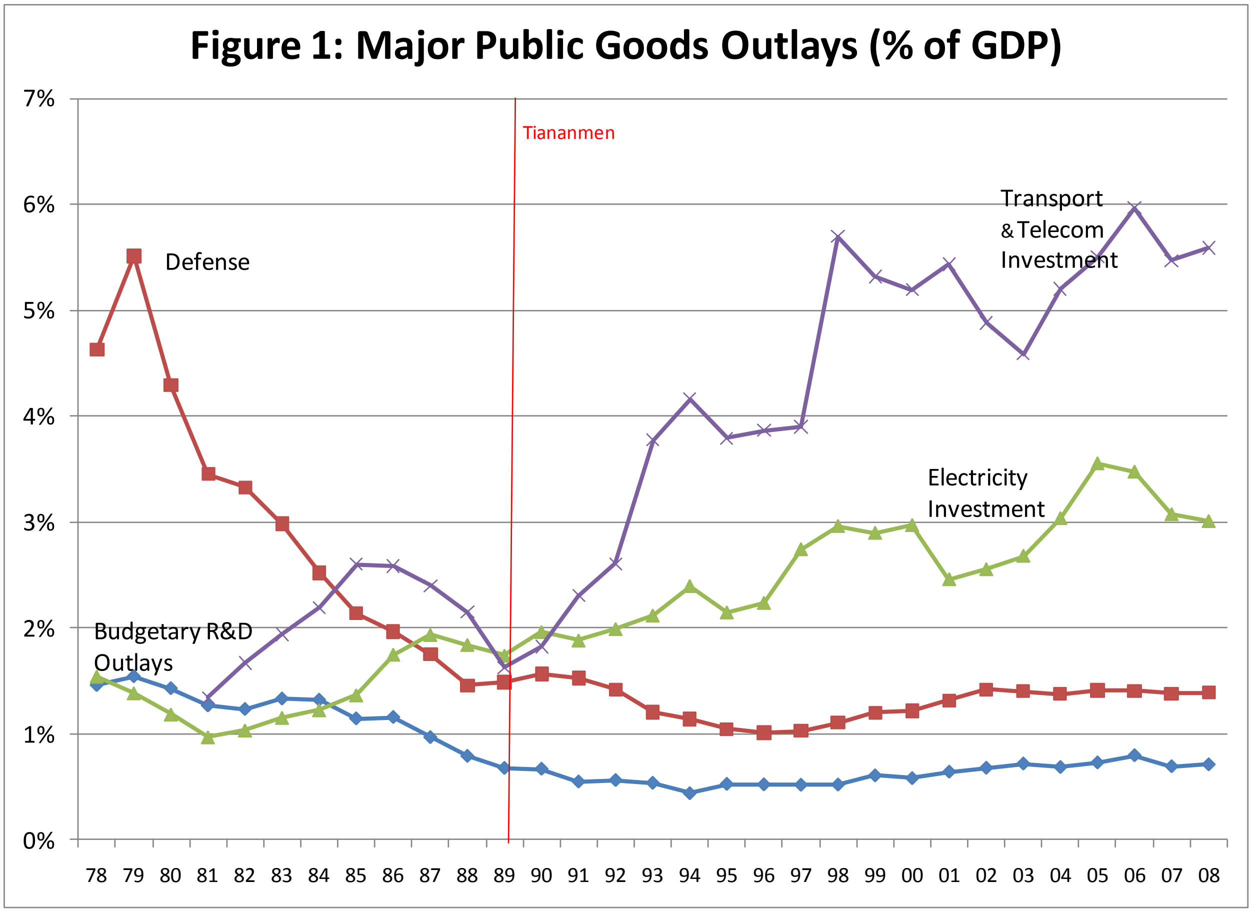


Figure 1: Major Public Goods Outlays (% of GDP)
7%
6%
5%
4%
3%
2%
1%
0%
Tiananmen
Defense
Transport
& Telecom
Investment
Electricity
Investment
Budgetary R&D
Outlays
78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08

Fig 2: Fiscal Revenues and Industrial SOE Profits

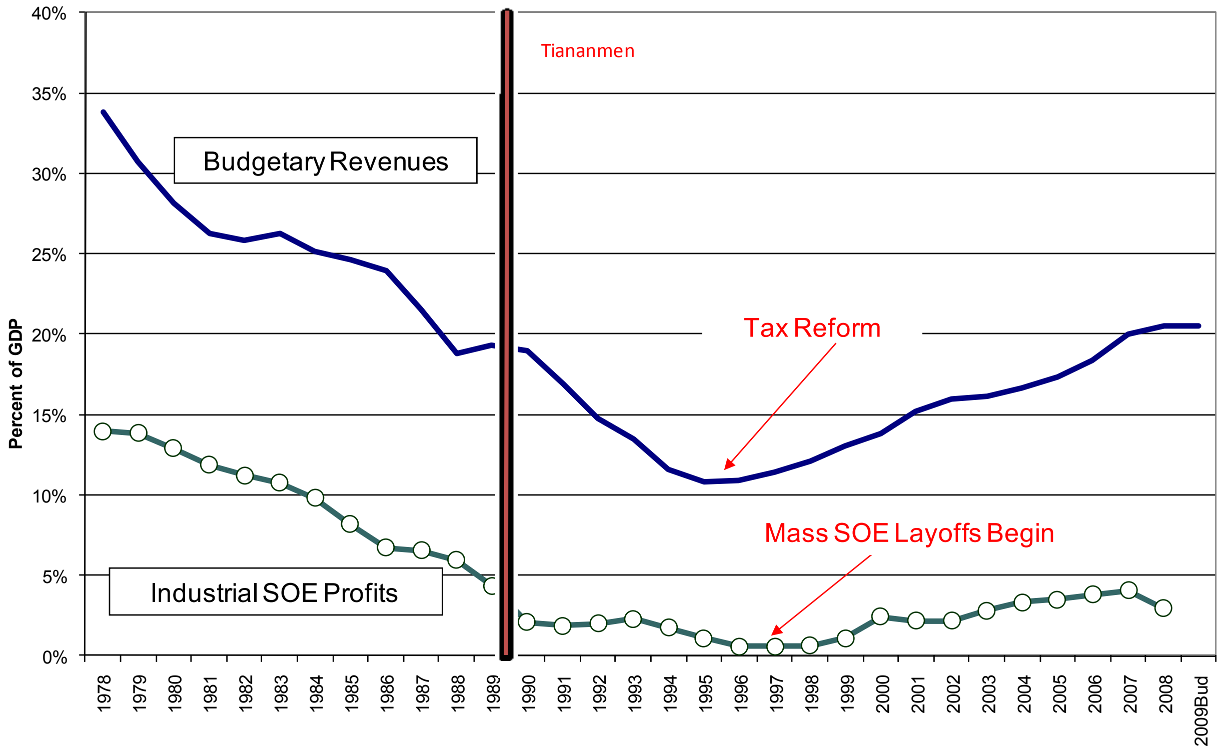
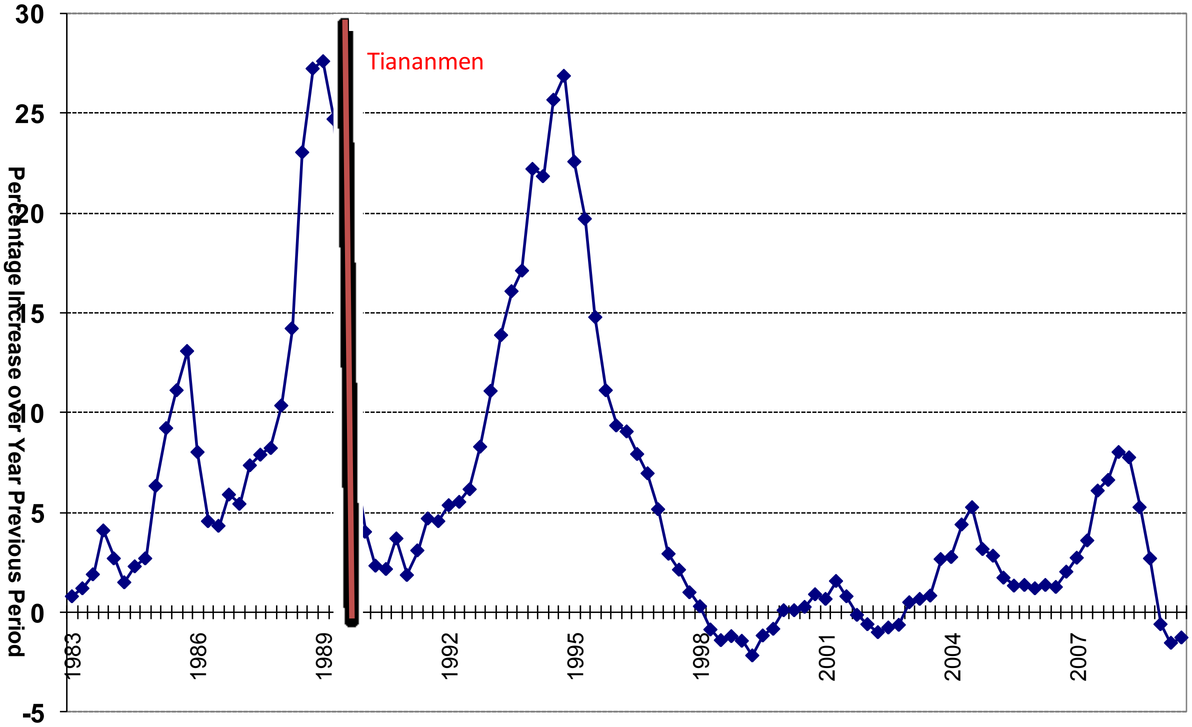


Fig. 3: Consumer Inflation (1983Q1-2009Q3)



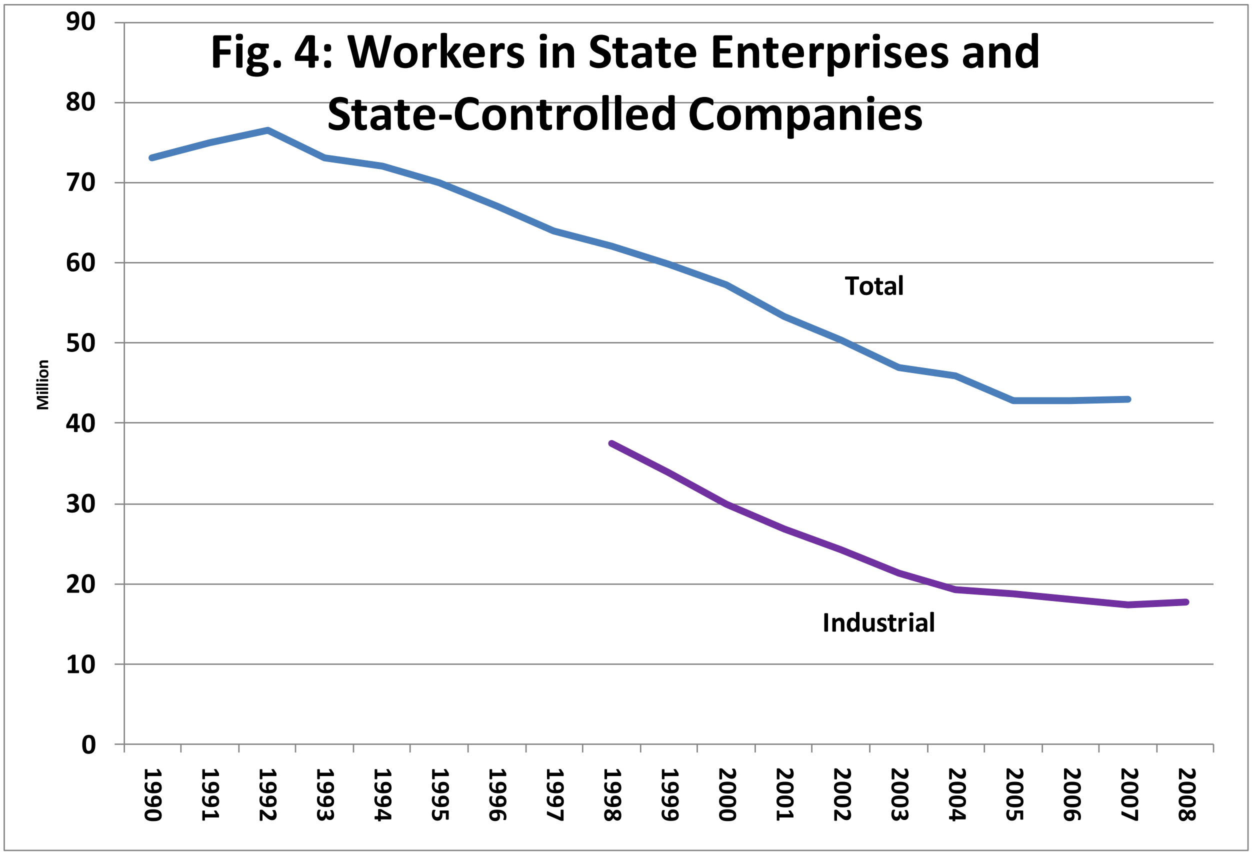


Fig. 4: Workers in State Enterprises and State-Controlled Companies
Million
90
80
70
60
50
40
30
20
10
0
Total
Industrial
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008

Figure 5: State Enterprise Sector: Center and Local (2007)

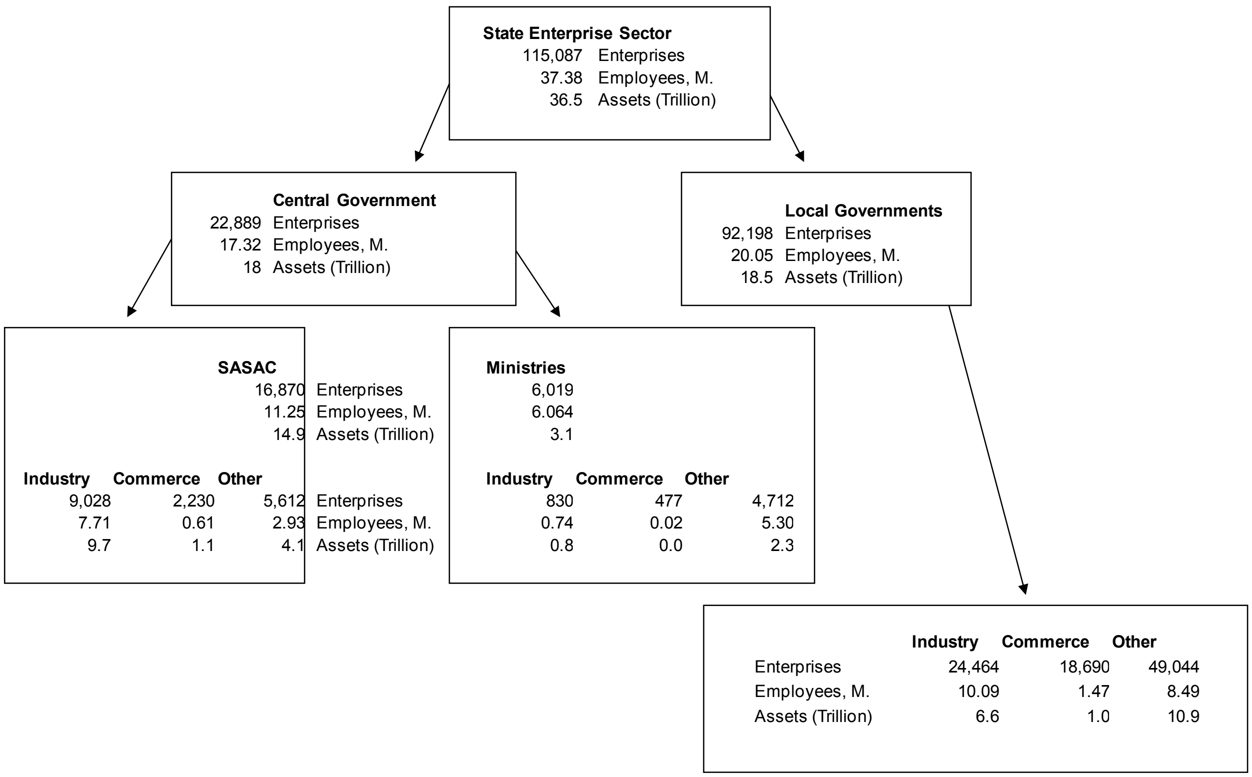


Table 1: Central SASAC Share of State Enterprise Workers

	2002	2007
All State Enterprise Employees (million)	50.3	37.38
of which: Central SASAC	8.6	11.25
Central SASAC Proportion	17.1%	30.1%
State Industrial Enterprise Employees (million)	24.9	18.544
of which: Central SASAC	5.9	7.713
Central SASAC Proportion	23.7%	41.6%
N.B. All Above-Scale Industrial Employees (M.)	54.73	78.75
Central SASAC Proportion	10.8%	9.8%

Source; Statistical Abstract (2003), p. 132; Lian Yuming; SASAC Yearbook (2007), pp. 587, 591; Statistical Yearbook (2008), p. 485.

Table 2: Central SASAC Share of State Enterprise Capital

	2002	2007
All State Enterprise Capital (Billion RMB)	n.a.	36,500
of which: Central SASAC	6,930	16,870
Central SASAC Proportion	n.a.	46.2%
State Industrial Enterprise Capital (Billion RMB)	8,972	17,090
of which: Central SASAC	4,336	9,700
Central SASAC Proportion	48.3%	56.8%
N.B. All Above-Scale Industrial Capital (B. RMB)	14,479	35,303
Central SASAC Proportion	29.9%	27.5%

Source; Statistical Abstract (2003), p. 132; Lian Yuming; SASAC Yearbook (2007), pp. 589, 592;
Statistical Yearbook (2008), p. 485.