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ABSTRACT

There is an influential, neo-liberal proposition in the scholarly literature on China's economic transformation since the late 1970s. It states that China's reformed economic institutions are a mix of market-conforming and market-supplanting elements, that its developmental achievements so far have been ascribable to the conforming elements whereas the accumulated problems being ascribable to the supplanting elements, and that the problems have tended to outweigh the achievements as the country's economic transition progresses from the allegedly easy phase to the difficult phase. This paper offers an alternative interpretation of the Chinese experience. The central proposition is that China's economic institutions could be seen in favourable light both theoretically and with reference to the East Asian development experience. Specifically, the developmental implications of the market-conforming and market-supplanting elements should not be understood in any absolute sense, but rather depend on the appropriate match or otherwise between the institutions and the external environment. The developmental achievements to date indicate that China's economic reform has managed to achieve a basically appropriate match between the two aspects, although enormous uncertainties still cloud over the future prospects owing to changes both in the external environment and the reform strategies of the state leadership.

Keywords: China, East Asia, late development.

1. Introduction

China is unique in having survived well the three waves of economic catastrophes that beset the non-Western world over the past quarter-century, commonly known as the era of globalisation. These catastrophes, namely, are: first, the ‘lost decades of development’ in most parts of the Third World since the early 1980s, second, the total crisis in countries of the former Soviet bloc since the mid-1980s, and, third, the financial and economic crisis that engulfed most parts of East Asia in the closing years of the century. This uniqueness is all the more surprising, given China’s economic institutions and development policies that have long been considered by the world orthodox establishment as by nature seriously deviating from the free market economy and hence being akin to the crisis-causing factors of the three entities indicated above. How, then, has this ‘China paradox’ come about?

There is of course no shortage of denial from the orthodox establishment in the world political economy that the Chinese experience is anything a paradox. A recurring popular claim has it that, given a long enough time span, an economic collapse of comparable scale is bound to beset the country, as a punishment for its deviation from the established world standards. At a more scholarly level, there has long been a proposition stating that China’s reformed economic institutions are a mix of market-conforming and market-supplanting elements, that its developmental achievements so far have been ascribable to the conforming elements whereas the accumulated problems being ascribable to the supplanting elements, and that the problems have tended to outweigh the achievements as the country’s economic transition progresses from the allegedly easy phase to the difficult phase. Hence, the future prospects for the Chinese economy is at best uncertain and more likely crisis-prone (writings in this tradition include Cao *et al.* [1997], Fan and Woo [1996], and Lardy [1998]; see also IMF [2000] and World Bank [2002]).

This paper offers an alternative interpretation of the Chinese experience. The central proposition is that China’s reformed economic institutions could be seen in favourable light both theoretically and with reference to the East Asian development experience. Specifically, the developmental implications of the market-conforming and market-supplanting elements should not be understood in any absolute sense – as believers of the free market model would have it – but rather depend on the appropriate match or otherwise between the institutions and the external environment. The developmental achievements over the past two decades indicate that China's economic reform has managed to achieve a basically appropriate match between the two aspects, although enormous uncertainties still cloud over the future prospects owing to changes both in the external environment and the reform strategies of the state leadership. The interpretation thus gives rise to policy implications that are very different from the orthodox prescription.

This paper is organized in five sections. Section two reviews the scholarly literature on East Asia's financial and economic crisis as well as its previous developmental achievements known as the 'East Asian miracle'. This leads to a number of observations that are, in turn, used as references for assessing China's economic reform and development in section three. From this perspective, the section identifies the main constraints faced by the Chinese state leadership and the main options opened to it in future economic reform. Section four turns to the more specific aspect of China's enterprise-level reform, which has been at the heart of the overall economic transformation. On the basis of empirical evidence, the section raises four main propositions which constitute an interpretation of Chinese reform experience that is in sharp contrast to the orthodox, market-centred visions. Section five draws some policy and analytical conclusions.

2. The 'East Asian Model', the Crisis and the Miracle

The financial and economic crisis that engulfed East Asia in the late 1990s gives rise to three analytical questions that require adequate answers (Lo [1999a] gives a synthesizing account of the main issues reviewed in this section). First, to the extent that the crisis was indeed related to the domestic political-economic institutions of the affected countries, why, then, were the basically same institutions capable of contributing to the previous, decades-long rapid and sustained economic growth known as ‘the East Asian miracle’? Second, given that there were in fact diverse institutions in the different countries affected at the time the crisis erupted, why did the crisis sweep to the region as a whole? Third, in view of the basically healthy macroeconomic conditions of the countries before the crisis, why did the crisis reach such a disproportionate scale?

As recounted by Wade (1998), interpretations of the East Asian crisis have coalesced around two rival stories – namely, the ‘death throes of Asian state capitalism’ story about internal, real economy causes; and the ‘panic triggering debt deflation in a basically sound but under-regulated system’ story that gives more role to external and financial system causes. The former story considers East Asia’s economic institutions as intrinsically inefficient, particularly because of the powerful influence of the state over the economy. The ‘panic’ story, in contrast, attributes the crisis mainly to the inadequate regulation of East Asian states over short-term international capital flows. It considers these capital flows as largely speculative and are prone to cause excessive volatility in the currency and financial markets. The spread of the crisis to the region as a whole and beyond in the form of contagion, in this view, confirms that financial panic itself is the main cause of the crisis. Furthermore, the nature of financial panic is such that it could combine with the contraction of demand to form a vicious circle of bankruptcy, financial market collapse, and more falling demand, thus pushing a weak economy into deep recession.

Wade’s taxonomy is useful for characterizing the existing interpretations of the East Asian crisis. However, by coupling the emphasis on internal causes with that on the real economy, and the emphasis on external causes with that on the financial market, this taxonomy appears to be too rigid. It precludes the analysis of the crisis in terms of a different way of combining the four aspects, particularly in terms of unravelling the relationship between the real-economic problems and the financial panic. Yet, it is clear that, whilst the ‘death throes’ story has difficulty in explaining the contagion, the ‘panic’ story does not really answer the third question indicated above: that is, why did the crisis in East Asia reach such an exceptionally large scale?

To answer this last question, it is necessary to examine the nature of East Asia's economic institutions in relation to the unfolding of the crisis. In a separate paper, Wade and Veneroso (1998) in fact explicitly take up this task. There, the essential message is that East Asia's 'high household saving, high corporate debt' economy is vulnerable to systemic shocks, especially if the shocks take the form of high interest rates, currency devaluation, or demand contraction. This is because high interest rates or currency devaluation would increase the cost of servicing debts, while demand contraction would reduce corporate profits. When interest payment is in excess of profits, firms would have no other option but to increase total debts. Yet, coping with the shocks this way is not usually possible in the context of East Asia where firms are already heavily in-debted. Moreover, because, unlike equity which requires a share of profits, debt requires a fixed level of repayment, firms would normally be alone in bearing the brunt of the systemic shocks. This makes their vulnerability to systemic shocks even more pronounced – hence the disproportional scale of the financial and economic crisis.

But, it is necessary to further clarify the developmental implications of East Asia's peculiar economic institutions, which mediate the 'high household saving, high corporate debt' model. The observation is not much in dispute: that the institutions deviate seriously from the canonical free market economy. The essential characteristic of the institutions – in the form of renowned arrangements such as the Japanese main-bank system, subcontracting, enterprise grouping, the practice of life-time employment, etc. – is to emphasize long-term relationships and the accountability of firms to all stake-holders (as opposed to share-holders alone). In other words, the institutions are infused with rigidities, implying a suppression of market regulation in the 'factor' markets. Is this characteristic a weakness or a strength? For, whereas orthodox economists simply use the term 'inefficiency' to characterize the nature of the institutions, dissident writers like Wade consider the vulnerability of the institutions as a necessary trade-off with the benefits of promoting the region's 'high-intensity investment, export-oriented' development path.

The significance of the ‘high-intensity investment, export-oriented’ development path is such that it bases the East Asian miracle on productivity growth, rather than on the notorious notion of cheap labour. A well-developed and influential body of studies have indicated that the productivity growth comes from two main sources: continuous innovation and industrial upgrading (Amsden [1989] and Wade [1990] are representative works in this tradition). For the former, an important form is collective learning effects. With the enterprise system being characterized by an emphasis on long-term relationships and accountability to all stake-holders, major agents in the system tend to have good incentives for developing work skills and improving production techniques, and these have been in turn translated into productivity growth via horizontal co-ordination mechanisms such as quality circles and just-in-time practices (Aoki [1990] gives a good exposition on this).

Turning to the matter of industrial upgrading, the debate in the literature has focused on the efficacy or otherwise of state intervention, particularly state industrial policy. What seems to be more crucial, however, is the precondition upon which industrial policy could be implemented – that is, high-intensity investment. For, such investment not only deviates from the ‘given’ international comparative advantage, but it also is of massive amounts and with slow returns in nature. It is unlikely to materialize purely under the regulation of the market, and, at the aggregate level, there is also a serious problem concerning the sources of funds. It is precisely at this point that the ‘high household saving, high corporate debt’ economy comes to play. Its concrete manifestation in East Asia is the bank-based (rather than market-based) financial system on the one hand, and, on the other hand, the state’s restrictions on financial market liberalization and its frequent intervention in the sector. All these combine to give rise to a development-oriented, reciprocity relationship, where firms exchange good performance for policy favours from the state authorities.

This said, however, writers in this tradition typically do not consider the advantages exhibited in East Asia’s economic institutions as in any sense absolute. Unlike orthodox economists who often compare the reality with the notional model of the free market economy (and hence the notion of the *natural* path of development) and characterize any deviation thereof as inefficiency, the writers have made it clear that the developmental implications of the institutions depend on their appropriate match or otherwise with the external, particularly demand-side environment. As Aoki (1990) puts it, in order that the institutions could promote collective learning and therefore productivity growth, the market demand environment must be continuously changing but in a steady fashion. A stable market environment tends to favour the (stylized) American-type big business which is infused with especially serious rigidities, whereas a rapidly changing environment tends to favour the atomistic firm of the arm's-length market relationship, which is highly flexible. It is in-between the two extreme conditions that East Asian institutions have their competitive advantage. The emphasis on the appropriate match or otherwise between institutions and the external environment thus provides an convincing answer to the first question indicated above: that is, why did the basically same institutions contribute to both the previous economic miracle and the later crisis? It also offers an insightful perspective for examining China's experience of economic transformation.

3. China's Economic Transformation: Contradictions and Options

Turning to the case of China, an immediate point to note concerns whether an East Asian-type financial crisis is likely to occur in the country. From the perspective of the financial panic story, that appears to be unlikely. After all, China has accumulated a huge amount of foreign exchange reserve, its foreign debts are well within a manageable limit, and the dependence of its economy on exports (either as a source of macroeconomic demand, or as a means to pay for needed imports) is of a low degree. All these, together with state controls over the capital account, leave very limited scope for the run on its currency and financial assets by international speculative capital. More fundamentally, and in the domestic front, it is well known that China's corporate debts are mainly domestic debts, that Chinese banks are state-owned, that the indebtedness of the state is within a manageable limit, and that there exists a huge amount of saving in the domestic economy – all these combine to imply that any problem of insolvency or illiquidity of economy-wide scale, if it does exist, could be resolved with no insurmountable difficulties.

This said, however, it is also well known that the Chinese economy does have its own, serious problems. The foremost one concerns its financial sector, or more precisely the problem of non-performing loans which has put the state banks at risk. Estimates of the scale of the problem vary widely, from an officially announced ratio of around 25% of non-performing loans to total bank lending to that of up to 50% according to foreign observers. A main reason that gives rise to the large gap among the different estimates is that the quality of a substantial proportion of total bank lending is contingent on the general condition of the economy. That, in part, explains the imperative for maintaining a substantial rate of economic growth in China. Whatever the actual scale of the problem, it is sufficiently serious to have prompted the state leadership to adopt a range of policies since late 1997 for restructuring and strengthening the banking sector. After all, from the perspective of the 'death throes' theory of the East Asian financial crisis, excessive lending by the banking sector was at the heart of the crisis. Though somewhat discredited for being a partial view, the 'death throes' theory does contain elements of truth and has been taken by the Chinese leadership seriously.

The problem of China's banking sector needs to be put in perspective. Succinctly, it reflects a much more fundamental contradiction in the country, after two decades of market reform. This, namely, is the weak financial position of the state itself – a contradiction arising from the state's obligation to maintain a sizeable state-owned economic sector on the one hand, and its shrinking share in national saving on the other hand. Figure 1 illustrates the first half of the contradiction. It is noted that the output, employment and capital shares of state-owned enterprises (SOEs) in Chinese industry, albeit having decreased massively, are still at substantial levels today. On the eve of the East Asian crisis, in 1997, SOEs accounted for 34% of value-added, 40% of labour employment and 42% of fixed assets of Chinese industry as a whole. Subsequent years till 2002 witnessed a massive shrinkage in the employment share to 26%, and a substantial increase in the capital share to 47%, while the output share remained at the same level of 34%. Outside industry, SOEs' output and capital shares in services sectors such as commerce, transportation and communication are higher than these levels.

[Figure 1]

Meanwhile, Figure 2 clearly illustrates the other half of the indicated contradiction: the shrinking share of the state in national saving. In terms of the deposits with financial institutions, the share of the state decreased from 32% in 1983 to 12% in 2002, whilst that of enterprises increased from 33% to 35% and that of households increased from 35% to 53%. And there was also a massive decrease in the GDP share of state revenue, from 26% in 1980 to around 11% in most years of the 1990s, before rebounding to 18% in 2002. All these have seriously constrained the capability of the state in investing in SOEs.

[Figure 2]

The main way through which the indicated contradiction has been resolved is precisely the mediation of state banks. As can be seen from Table 1, despite all the reforms in financial liberalization, state banks have continued to control a vast-majority share of total loanable funds in the economy. In 2001, they accounted for 81% of the total of credit funds used, and 77% of loans, of all financial institutions in China. Put another way, the state has been in a position of virtually monopolizing the allocation of financial resources in the economy. As a result, and in conjunction with the state policy of under-capitalization since the lending-for-appropriation (*bogaidai*) reform in 1983, where bank lending replaced state budgetary allocation as the main source of external financing for industrial firms, China's industrial SOEs (as well as SOEs in other sectors) have become seriously indebted. Their average debt-to-asset ratio increased from 19% in 1980 to the peak of 79% in 1994, before gradually decreasing to 59% in 2002 (see Chan [1998] for an analysis of this development, and data from various issues of *China Statistical Yearbook*). The other side of the coin is thus heavy burdens on state banks in the form of expanding non-performing loans, amid the secular decline in industrial profitability particularly because of the slowdown of economic growth in the second half of the 1990s.

[Table 1]

From the description above, it is clear that, after two decades of reform, China has become similar to the typical East Asian economies in having a ‘high household saving, high corporate debt’ economic pattern with the state playing a central role in mediation. If the discussion in the previous section regarding the developmental implications of such a pattern contains elements of truth, it is logical to consider the extent to which China would be able to re-play the acclaimed East Asian miracle, on top of its own miracle of the past two decades. For, the economic pattern provides grounds for establishing a reciprocity relationship whereby enterprises use good performance to exchange for state favour in capital allocation – a relationship that has been regarded by many economists as essential to successful late development. The fact that China’s non-SOEs also have a comparable level of indebtedness reinforces the leverage of the state in promoting economic development along this line. The crucial question here, however, is: what kind of enterprise performance?

At one level, there are issues related to the demand side. It is clear that China has been capable of achieving the first half-part of the East Asian model of development: that is, high-intensity investment for the development of dynamic industries. But, it is far less certain with regard to the second half-part, namely, the degree of export-orientation that is sufficient for realizing the increasing returns and/or technological externalities of the established industries. In the context of the prevailing world political-economic conditions, Chinese industry is bound to face intensifying trade restrictions in foreign markets and competitive pressure from foreign firms in the home market. Thus, ultimately, it has to fall back on the support of domestic demand. This point will be picked up again and looked at in more details in the next section.

At a more fundamental level, there is the question concerning the responsiveness of Chinese enterprises, SOEs in particular, to the imperative of late development. Put in another way, without sufficient entrepreneurial initiatives and capabilities in the corporate sector, the reciprocity relationship might simply break down and the hope-for developmental objectives could not be achieved. To address this question, it is necessary to turn to the analysis of the past achievements of and future prospects for China’s enterprise reform.

4. Enterprise Reform and Development: A Re-interpretation

Any appraisal of China's enterprise reform over the past two decades must begin with looking at the actual experience, rather than with notional 'first principles' of economic theory. For, the experience has been known to many observers as a paradox for standard economic theory. Three quick indications below suffice to demonstrate this point (for an elaborated account of China's enterprise reform and development along this line, see Lo [1999b]).

The first point that comes out is a trend in Chinese enterprise development that is in sharp contrast to widely-held perceptions. Between 1978 and 2002, the value-added share of large-scale enterprises in Chinese industry not only was held stable but rather increased, from 31% to 36%. And the vast majority, still around 75-80% by the turn of the century, of these enterprises are in fact SOEs. Thus, there is a paradox needing explanation: given that large-scale enterprises are after all the core of China's state economic sector, what has accounted for their expanding output share in the reform era?

Figure 3 presents yet another paradox. The pre-tax profit rate (i.e., profit-to-capital ratio) of SOEs has been very close to Chinese industry as a whole throughout the reform era – slightly higher in the 1980s, slightly lower in the 1990s. And large-scale enterprises have persistently outperformed other enterprise sectors, both SOEs and non-SOEs, in this regard. Again, how did all these come about?

[Figure 3]

The above two pieces of evidence stand in contrast to the widely-held perception, or allegation, that China's industrial SOEs have done poorly both financially and in terms of productive efficiency. Moreover, recall the discussion in the previous section on the 'fundamental contradiction' in the Chinese economy, which implies that the main cause of the financial difficulty of the state sector lies in the state itself, rather than the under-performance of SOEs. In contrast to the allegation that SOEs have been a drag on the economy in the form of taking up state subsidies and generating bad loans for state banks, the distributive relationship between the state and SOEs has been characterized by surplus transfer from the latter to the former. Thus, the respectable performance of SOEs as indicated above has in fact been achieved despite the state policies of extraction and under-capitalization (Lo [1999b] provides a detailed analysis of these issues).

The data in Table 2 indicate that, throughout the reform era, the state policy of under-capitalizing SOEs has been in effect. Compared with other ownership sectors, SOEs has been facing an especially heavy burden of taxation. At its extreme, the ratio of after-tax to pre-tax profit for SOEs was a mere 0.15 in 1997, which was less than a half of that of collectively-owned enterprises, and less than a third of that of private firms, share-holding enterprises and foreign capital-funded enterprises. And this policy has been implemented despite the secular decline in enterprise profitability, reflected in Figure 3, as well as the fiscal system reform after 1994 that was purportedly aimed at providing a level playing field for enterprises of all ownership sectors (Cheng and Lo [2002] argue that the secular decline in industrial profit rates has been caused mainly by the worsening demand-side, macroeconomic conditions, rather than by worsening efficiency on the part of SOEs and other enterprises). This piece of evidence, again, runs counter to the widely-held perception that SOEs have been especially favoured by the state.

[Table 2]

Thus, the nature of China's enterprise reform, of SOEs in particular, needs rethinking. At one level, the reform could be characterized as a process of the state hiring and motivating managerial services in the corporate sector. At another level, however, this process has evolved within a context of the broader reform which involved main stake-holders both inside and outside the enterprise – local authorities, workers, local communities, banks and related business entities – to form a system of check and balance in enterprise development. The evolution of the reform from the profit-retention system to the tax-for-profit reform (*ligaishui*, where income tax replaced profit delivery as the main form of state extraction), the contract management system and finally to the corporatization drive aimed at establishing the modern corporate system, clearly reflects this character. Thus, China's reformed enterprise system has become similar in nature to the canonical East Asian system that is infused with institutional rigidities and long-term orientations. From the discussion in Section 2, there are established economic theories to explain the competitive advantage (and disadvantage) of enterprise systems of this kind. Succinctly, in the context of steadily expanding market demand, institutions that are infused with rigidities and long-term orientations have the advantage of promoting productivity growth through dynamic increasing returns, particularly collective learning effects. The down-side of such institutions, though, is their inflexibility in adjusting to cope with demand contraction. The fact indicated above that China's SOEs basically outperformed non-SOEs in the boom years of the 1980s but were outperformed in the demand-deficient years of the 1990s could be seen in this light.

To the extent that the depicted performance is indeed related to these institutional arrangements, two analytical questions can then be asked: first, how is the reformed Chinese enterprise system distinguished from the traditional Soviet-type system, and, second, what positive effect on enterprise competitiveness might be generated by this system, amid the loss of allocative efficiency that is (theoretically) likely to be caused by otherwise sub-optimal arrangements? Bearing in mind the advantage and limitation of formal statements, these questions are answered by means of the four propositions detailed below.

Proposition 1: Soft budget constraints as a necessary condition for corporate entrepreneurship.

It has long been held that soft budget constraints are a fatal weakness of the traditional Soviet-type system. But what precisely is a soft budget constraint? Kornai (1980) uses the term to summaries a set of behavioural phenomena – notably that the survival of the enterprise is guaranteed by the state, and that its expansion involves an asymmetry between reward and punishment – and posits that these are endemic to public ownership in a structural sense. But, in the literature on China's reform experience, Hua *et al.* (1986) argue that the structural condition for constraining soft-budgeted behaviour is less generic: what is needed is the clarification of the boundary of interests of enterprises. Zhang (1987) further makes the point that so long as the soft external financing does not blur the cost-revenue structure of the firm, it would not leave much room for soft-budgeted behaviour.

In practice, the hardening of China's enterprise budget constraints is achieved mainly through increased product market competition. This, coupled with enhanced autonomy and incentives, institutionalizes the interests of enterprises. In respect of external financing, the afore-mentioned lending-for-appropriation financial reform also appears to have brought about the effect of hardening budget constraints. By replacing bank lending for state allocation, it reduces the shortcomings of the previous system which blurred the cost-revenue structure of enterprises. By requiring payment for the cost of external financing, the reform also forces enterprises to economize on its uses (Wang and Li 1991).

Not only has the reformed enterprise system curtailed the previous shortcomings, but it has also promoted entrepreneurship. Conceptually, a hard budget constraint can be achieved only when the firm is strictly under the discipline of the market, particularly the market for corporate control and the managerial market – the ideal state of property rights theory (Demsetz 1983; Kornai 1990). However, in the theoretical literature, there are well-developed arguments that strict market regulation tends to produce short-termism and volatility. The planning horizon of external financing entities (which must be utility-maximizing, natural-personal individuals if hard budget constraints are to be achieved) can be much shorter than what is required for productive/entrepreneurial activities. A certain degree of soft budget constraints is thus necessary for the long-term pursuits of firms. In a similar vein, compared with the managerial market, an internal promotion ladder that extends to the top management is more capable of enhancing the long-term commitment of inside members of the firm and hence their pursuit of long-term, entrepreneurial endeavours (Lazonick 1991; Teece 1993).

In the context of China, an economy under systemic reform and structural change, it is conceivable that the development of entrepreneurship takes time and that this development can be interrupted by fluctuations in the institutional and developmental environment. Hence, a soft budget constraint is instrumental in protecting potentially efficient firms from being wiped out by the fluctuations (though it also protects inefficient firms at the same time). It should be noted that virtually none of the Chinese enterprises that compete successfully in the world market today could be regarded as efficient ten years ago.

The rationalization drive in Chinese industry in the 1990s is especially illustrative of soft budget constraints as a necessary condition for corporate entrepreneurship. This drive, which took the form of mergers and take-overs on a massive scale, has greatly improved the structures (and international competitiveness) of a wide range of dynamic industries. These rationalization activities are clearly entrepreneurial, and have been largely initiated by the enterprises themselves (Jiang *et al.* [1993]; Lo and Chan [1998]; SCESR [1992]). As even these entrepreneurial firms (mostly *qiye jituan* or industrial groups) were small in scale relative to the rationalization activities and had faced severe financial constraints, it is certain that the activities could not have taken place without the scope allowed by soft budget constraints.

Proposition 2: Government intervention as a surrogate for (underdeveloped) corporate entrepreneurship.

The issue of government intervention can be viewed in the same way. It is not the place here to summarize the theoretical arguments for and against government intervention in the vast development literature, but suffice it to say that the same arguments concerning soft budget constraints – i.e., protecting efficient firms against fluctuations and facilitating their long-term endeavours – can apply. Moreover, in the context where corporate entrepreneurship is underdeveloped, the government can act as a surrogate (though of course it can also make mistakes). This is indeed a general thesis developed by writers like Amsden (1989) and Wade (1990) who, among others, argue that an essential feature of East Asian industrialization is the entrepreneurial role played by the government.

The rationalization drive in Chinese industry in the 1990s is again illuminating in this regard. Especially in the initial phase, the mergers and take-overs took place mainly among enterprises of the same regions. This indicates the crucial role played by local authorities. In the meantime, there are other activities initiated by local authorities which have proved to be important in improving the efficiency and international competitiveness of Chinese industry –

the promotion of joint R&D activities for indigenizing imported technology being a case in point. These again can be regarded as entrepreneurial.

As for curtailing the negative effects of government intervention, the specific form of reform has proved crucial. The contract management system implies the institutionalization of a bargaining regime, where local authorities are involved in enterprise decision-making, while abandoning the pursuit of an arm's-length state-enterprise relationship that is supposedly required by the principles of the market. But, there is an important difference between the new bargaining regime and that under the Soviet-type system: the bargaining now centres around financial performance, instead of inputs allocation and outputs delivery which are characteristic of central planning. This curtails the room for soft-budgeted behaviour on the part of enterprises. It also implies that government intervention becomes more formal, or less *ad hoc*, because it is largely carried out via the unified contract-issuing committees instead of the industrial bureaux and other offices that are not well co-ordinated.

The formation of industrial concerns since the late 1980s has also proved capable of restructuring the state-enterprise relationship in a way that reduces crucial deficiencies in government intervention. This is related to its dealing with the immobility of productive assets across localities or ministerial affiliations. Especially in fast growing industries, there are cases whereby nationwide industrial concerns take over the control of enterprises from the concerned local authorities. The latter thus become shareholders, and their intervention in enterprise operations becomes less *ad hoc* than previously.

Proposition 3: The employment relationship as idiosyncratic exchange.

It is well-known that China's employment system has been characterized by both low labour mobility and rigid wage adjustment. It is also well-known that the reform has fallen far short of official targets. At least until the 1995-97 enterprise downsizing drive, measures like dismissal and widening wage differentials have rarely been practised, whereas workers through a collective bargaining regime can have considerable influence over the distribution of enterprise surplus. All these are problematic from a standard neoclassical, or neo-liberal, point of view.

Nevertheless, in the theoretical literature, there are alternative theories arguing that a rigid employment relationship does have merit. The idea of idiosyncratic exchange raised by Williamson *et al.* (1975) is representative of these theories. Essentially, it says that some degree of rigidity in the employment relationship can help to establish the loyalty of workers, and thus can be more conducive – than the standard emphasis on strictly linking short-term, individualistic performance with reward – to the performance of firms. This rests on the premise that there are significant gains from firm-specific, or idiosyncratic, knowledge acquired by incumbent workers. In the context of late industrialization, this theory has been pushed further to incorporate two more points: first, that learning is a collective activity and, second, that the learning effect is actively generated by workers and is thus not marketable. Hence, from the standpoint of promoting the productive efficiency of the firm, co-operation is required not only between the two sides of the employment relationship but also among major participants of the production system as a whole (Best 1990).

In China, the contribution of the rigid employment system is particularly evident in the application of a range of operational practices such as the Japanese-style just-in-time (*kanban*) system, quality circles, workers' suggestions for operational improvement, etc. The significance of these practices is that, just like the Japanese case, they are essential to the flexibility of enterprises in responding to fluctuations in market demand. However, and again just like the Japanese case, flexibility-based practices – which by lifting buffer stocks implies rigorous demand for on-site quality control and problem-solving – cannot be successfully instituted without the active participation of the workers. The rigid employment relationship, which fosters the long-term commitment of workers, is thus crucial in this regard.

Finally, regarding the curtailment of the negative effects of the rigid employment system, positive achievements have also arisen out of China's specific reform measures. One major measure is 'unemployment inside the enterprise', which is analogous to lay-offs in capitalist countries but with the unemployment insurance coming from the firm rather than from the state. Except in 1995-97 when outright firing was a widespread practice amid the state-encouraged drive of downsizing, this measure has promoted competition among workers for formal jobs, with those outcompeted becoming ‘unemployed’ but continuing to stay in the enterprise. These workers only receive a basic wage, rather than wage plus bonus, and have to face the embarrassing status of working at informal jobs (Liu 1993). Thus, by strengthening the link between reward and performance, the reform has helped to enhance work incentives. The strengthening of the link between the income of the inside members as a group and that of the enterprise under broader reforms has also helped to bring about peer group pressure on individual workers for good performance.

Proposition 4: The competitiveness of the firm depends on the match between the organizational form and the growth pattern.

The discussion above thus clarifies the general thesis that the substitution between market and (non-market) institutional regulation implies a trade-off between allocative and productive efficiency, and that the seemingly sub-optimal arrangements of China’s reformed enterprise system can be viewed in this light. But the question remains unanswered as to what is the link between the enterprise performance and the characterized institutions. Precisely because the sub-optimal arrangements can have both favourable and detrimental effects on enterprise efficiency, it is necessary to investigate under what circumstances the outcome of the reformed enterprise system, on balance, will be positive.

Aoki’s (1990, p.9) view, as indicated in section 2, provides some insight: ‘(in the situation) where external environments are continually changing but not too drastically, the J-mode is superior. In this case, the information value created by learning and horizontal coordination at the operational level may more than compensate for the loss of efficiency due to the sacrifice of operational specialization.’ The net outcome thus depends on the pattern of economic growth. This view is in line with the discussion on techno-economic paradigm that is now the focus of various strands of economics: neo-Schumpeterian theory of innovation, flexible specialization, structuralist economics, the French regulation school, etc.

A common theme of these strands concerns the connection between the nature of technical change and the demand conditions, the latter being in turn regulated by social relations. An appropriate match between the two sides (e.g., mass production and mass consumption) can greatly promote productivity growth, whereas a mismatch can cause crisis. But late developing countries are prone to have mismatch because of their position as technology followers, and of possible consumption demonstration effects from developed countries (for a survey of the theoretical literature, see Lo [1995]). At the micro-level, firms in late developing countries face continually shifting demands towards new products, which implies good rewards for early entrants. Hence, successful adoption and improvement upon imported technology can be crucial for competitiveness. This is even more so if the environment is coupled with rapidly expanding demand, which promotes productivity growth through (dynamic) economies of scale.

In this regard, there is ample evidence suggesting that China’s pattern of economic growth over the reform era has been basically of this kind. Specifically, the crucial role of technology imports and changing market demand is associated with the explosive expansion of the ‘new (consumer durables) industries’, the impact of which has been felt by the entire Chinese population. These industries are in general characterized by high income elasticity of demand and rapid technical change. As a consequence, the capabilities of collective learning of SOEs, underpinned by their relatively more rigid institutional arrangements, are likely to have been an important source of their competitiveness (Lo [1999b] presents evidence on this from a range of descriptive and regression analyses).

The discussion finally leads to a coherent explanation of the features of China’s enterprise performance depicted in the beginning of the section. The crux is that rigidity (or flexibility) has both its merits and defects with respect to enterprise performance, and the outcome on balance depends on the wider context of the pattern of economic growth. As indicated above, in the boom period of the 1980s, SOEs outperformed non-SOEs in financial terms. In the demand-deficient period of the 1990s, however, SOEs were outperformed. At the extreme, during the recession years of 1989-91, whilst as many as one-third of collective township and village enterprises stopped operations or went bankrupt, the same phenomenon was rare for SOEs. The dismal financial performance of SOEs in the major part of the 1990s thus can be attributed to two main reasons. First, without the exit option, SOEs have had to keep on running even in times of recession and weak market demand. Second, because of the rigidity of wage adjustment, the unit cost of production has tended to go up amid contraction of the production scale.

On the whole, China's experience of enterprise development appears to confirm the thesis that rigid institutional arrangements of the kinds depicted above are bad for enterprises in responding to severe market fluctuations, but are good for improving productivity in the context of steadily expanding demand. The comparison of financial performance between SOEs and non-SOEs can be explained in this way. The fact that small-scale SOEs have been persistently outperformed by both large scale SOEs and non-SOEs suggests that, in their case, the gain from rigidity is not sufficient to compensate for the loss from lacking flexibility.

5. Conclusions

Viewing China's reform experience in the light of the East Asian development experience, and of late development in general, gives rise to significant implications. From the analysis in the preceding sections, it can be posited that a central characteristic of China's market-oriented economic system reform is the gradual shift of the orientation of the state from socialist commitments to developmental concerns. The massive shrinkage of the output share of SOEs in Chinese industry is a clear indication of the decline in socialist commitments. The retention of a sizeable and expanding sector of large-scale enterprises under state control, however, indicates that the state has not re-oriented itself to embrace the orthodox free market model. It rather indicates a primarily developmental concern: the state is to retain control over the commanding heights of the economy and thereby to direct the overall development, amid the general direction of mercerization. This is largely in the spirit of the East Asian model of late development.

And there are well-developed theoretical arguments in support of the model in achieving development. In particular, it could be argued that the sources of entrepreneurship, which is the central element of development, could be multiple. Entrepreneurship could be a collective activity as well as an individualistic one, with their relative advantages depending on their appropriate match or otherwise with the macro and developmental conditions. Notions such as the ‘entrepreneurial firm’ and the ‘developmental state’, which flow out from the literature on East Asian experience, are thus of relevance.

In this connection, however, the widespread over-capacity in Chinese industry since the mid-1990s and, more generally, the phenomenon of deflation are clearly antithetical to the feasibility of adopting the East Asian model in China. The short-term cause of the phenomena is discernibly the 1995-97 drive of enterprise downsizing enforced by the state, i.e., its policy of ‘grabbing the big and letting-go the small’ (*zhuada fangxiao*). By design or by default, the policy was seized upon by local authorities of various levels to sell off SOEs and lay off workers. The possibility of facilitating enterprises to grow out of over-sizing, in contrast, was scarcely considered. Meanwhile, it is also discernible that the phenomena of over-capacity and deflation can be to a significant extent attributed to a long-term trend in income distribution: the deteriorating position of the bottom layer of the society, both urban and rural, which however tends to have a higher marginal propensity to consume. Overall, therefore, the transformation of China’s economic system in the direction of the free market model appears to be incompatible with the pursuit of the East Asian model. Whether or not this is the case, by undermining egalitarian income distribution and the arrangements for collective learning, the transformation clearly leaves little scope for the pursuit of socialism.

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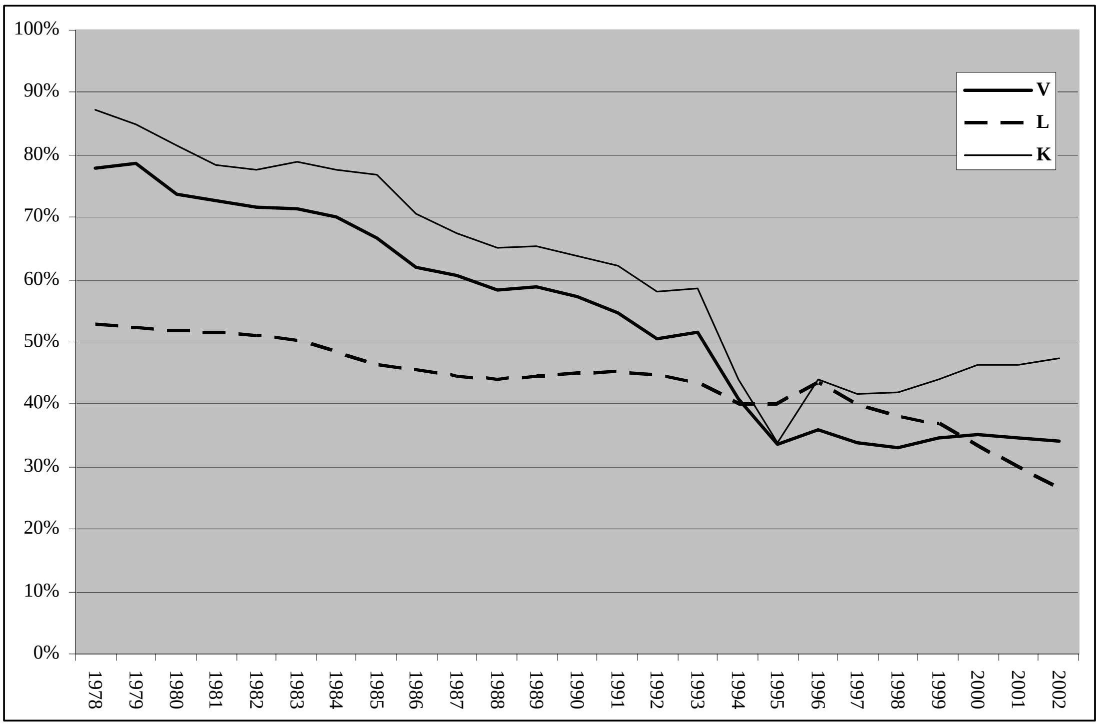
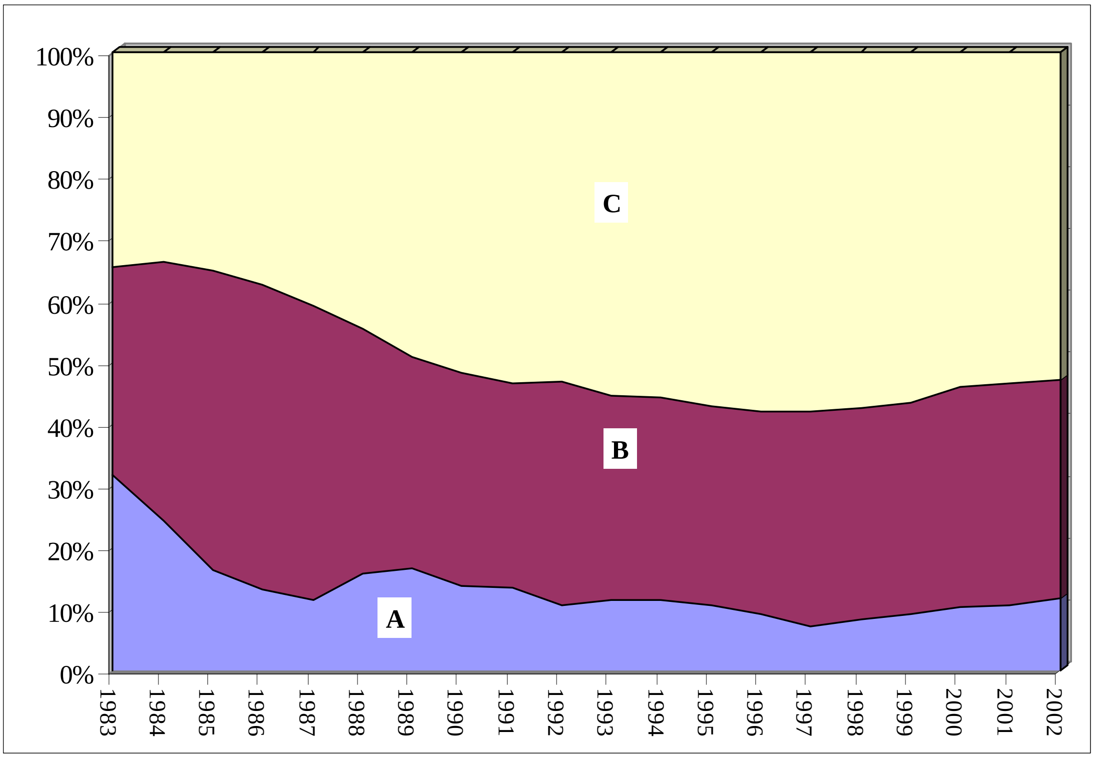
Figure 1. SOEs' Shares of Output, Employment and Capital in Industry, 1978-2002



Sources: *China Statistical Yearbook* and *China Industrial Economics Statistical Yearbook*, various issues.

Notes: V = value-added at current prices, L = labour employment, K = net value of fixed assets. Figures are shares of SOEs from 1978 to 1995 and of SOEs plus state-controlled shareholding enterprises from 1996 in Chinese industry as a whole.

Figure 2. Shares of Deposits with Financial Institutions, 1983-2002



Sources: *China Statistical Yearbook* and *Almanac of China's Finance and Banking*, various issues.

Notes: A = state; B = enterprises; C = households. Data for 1993 and before are of state banks, while those for 1994 and after are of all financial institutions.

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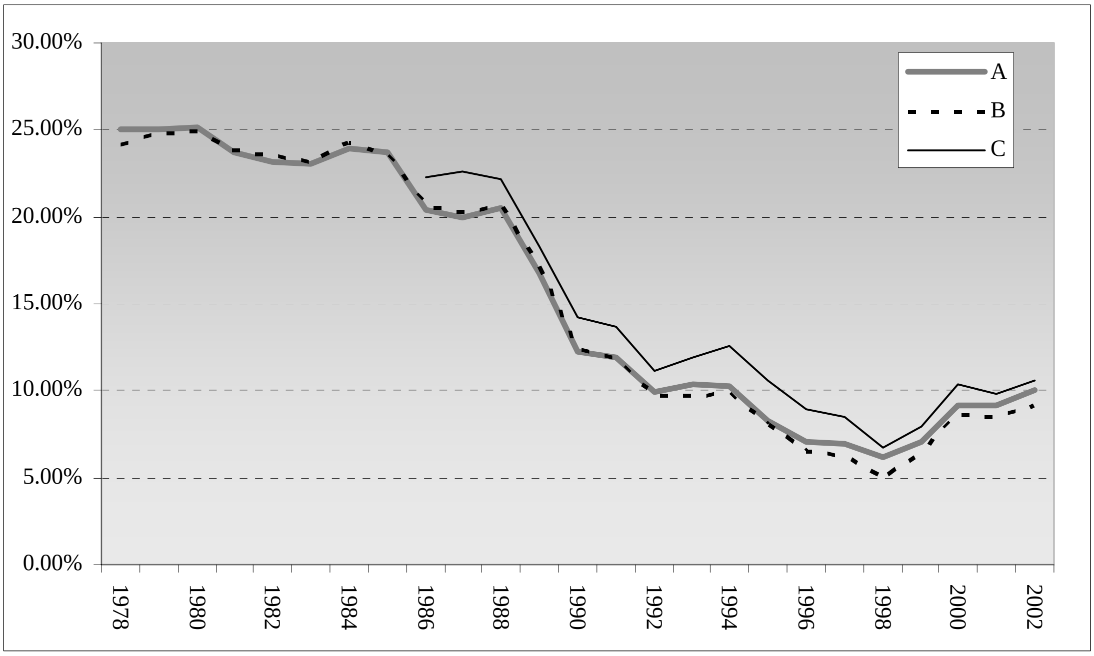
Figure 3. Pre-tax Profit Rates of Industrial Enterprises, 1978-2002



Sources: *China Statistical Yearbook* and *China Industrial Economics Statistical Yearbook*, various issues.

Notes: Pre-tax profit rate = (total taxes + total profits) / (working capital + net value of fixed assets). A = all enterprises, B = SOEs, C = large-scale enterprises.

Table 1. Uses of Credit Funds of Financial Institutions, 1996 and 2000

		Uses of funds total (100 m yuan)	Of which: loans (100 m yuan)
1996	All financial institutions	76971	61153
	State banks	63247	47435
	Share of state banks	82%	78%
2000	All financial institutions	135484	99371
	State banks	110129	76394
	Share of state banks	81%	77%
Sources *Almanac of China's Finance and Banking 2001*, pp.374-375.			

Table 2. Pre-tax vs. After-tax Profit Rates of Enterprise Sectors, 1986-2002

		Total	Of total:			Of total:
			SOEs	COEs	OOEs	LEs
1986	(a) pre-tax	20.43%	20.65%	19.36%	23.29%	22.25%
	(b) after-tax	10.77%	10.62%	11.15%	14.87%	11.26%
	(b)/(a)	0.53	0.51	0.58	0.64	0.51
1991	(a) pre-tax	11.88%	11.81%	11.89%	12.85%	13.72%
	(b) after-tax	3.42%	2.86%	4.49%	7.44%	3.71%
	(b)/(a)	0.29	0.24	0.38	0.58	0.27
1997	(a) pre-tax	6.92%	6.27%	8.27%	7.39%	8.51%
	(b) after-tax	2.05%	0.92%	3.19%	3.67%	2.91%
	(b)/(a)	0.30	0.15	0.39	0.50	0.34
2002	(a) pre-tax	10.00%	9.14%	12.22%	11.14%	10.53%
	(b) after-tax	4.81%	3.64%	6.68%	6.56%	5.00%
	(b)/(a)	0.48	0.40	0.55	0.59	0.48

Sources *China Statistical Yearbook* and *China Industrial Economics Statistical Yearbook*, various issues.

Notes SOEs = state-owned enterprises; COEs = collectively-owned enterprises; OOEs = other ownership-type enterprises, including share-holding enterprises, private enterprises, individually-owned enterprises and foreign capital-funded enterprises. LEs = large-scale enterprises.