



# ECONOMIC REFORMS IN CHINA: WHAT LESSONS FOR INDIA?

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## Abstract

*China started its market oriented reform process in 1978. Reforms have covered all major sectors of the economy including agriculture, industry, finance, international trade and investment. The major characteristics of reforms are managerial autonomy, decentralized decision-making and the opening up of the economy. Reforms have resulted in higher productivity and higher economic growth. China became the fastest growing economy of the world through the reform process. The entry into the WTO will further deepen the reforms. Recent years have witnessed dramatic rise in India's interest in China, mainly because of the poor performance of Indian economy as compared to China. India has lot of lessons to learn from China's reform process. Some of the lessons are: (i) India should give emphasis on agricultural sector which has been neglected so far in the reform process, (ii) efforts should be made to attract more FDI, (iii) trade should be liberalized more removing restrictions so as to integrate the economy with the world economy, and, (iv) attention should be paid towards the development of high quality infrastructure. Precisely, India should push her second-generation reforms forward to catch up with China.*

*Key Words: China, Economic Reforms, Productivity, State Owned Enterprises, Foreign Direct Investment, Economic Growth.*

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# I. The Background

China has the fastest growing economy of the World. The present higher economic growth can be attributed to the economic reforms, which started in 1978. The economic reforms in China were the result of dissatisfaction over the pace of economic growth that China had as compared to the East Asian neighbors. The aim of China's economic reforms was to improve the performance of the economy rather than establishing a market system. Therefore, reforms have been slow and uneven. China followed a gradual approach to economic reforms rather than going for a big bang. However, it covered all major sectors of the economy.

Though economic reforms have started long back, the efforts towards WTO membership have greatly deepened the reform process in China. China officially joined WTO in January 2002 and has become 143rd member of World Trade Organization (WTO) ending 15 years battle to get accession to the World trading body. China has been making attempts to get into the framework of globalized trading system since 1986. Now, entry into the WTO will give a further fillip to the reform process. Fulfillment of WTO obligations would make China a fully open market economy within a short period.

Recent years have witnessed dramatic rise in India's interest in China. China is considered as a major competitor for India in future. Whether it is overall economic growth, or growth in agriculture, industry, service sector, export or foreign direct investment, India's performance is always compared with China. India has been looking at the Chinese economy very closely as if we have something to learn from them. China's entry in WTO has further increased India's interest over their economy.

The broad objective of the present paper is to review the economic reforms in China in various sectors of the economy since 1978 and draw some lessons for India in the light of the progress China has made on the economic front.

## II. Economic Reforms in China

### Reforms in Agriculture and Rural Sector

Of all reforms, reforms in agriculture and in rural areas have been most significant and most widespread (Sandaresa, 1995). As a part of reform in agriculture, collective agricultural system was dismantled and household agriculture system restored. In the beginning, Chinese reforms were concentrated in the rural sector. The core of the reforms in agriculture was the introduction of the household responsibility system.

Under the household responsibility system, farmers were given the right to use the land for a period of 15 years with considerable autonomy in management of the land. Farmers were permitted to sell in open market at a competitive price the surplus they produced in excess of the target fixed by state. The increased agricultural prices and the restoration of family farming have resulted in the increased production and productivity. Between 1978 and 1985 agricultural output increased by 10 percent per annum while per capita income of farmers went up by about 90 percent. This has increased the demand for consumer goods forcing the reorganization of the industrial sector. It is the reforms in the agricultural sector, which led the reforms in the industrial sector. The surplus savings generated and the labours released from agriculture, due to higher production and productivity, made the way for industrial reforms and development. Beginning in 1984, China shifted its reform priorities to the state owned industrial sector.

## Reforms in Industrial Sector and State Owned Enterprises (SOEs)

The essence of economic reforms in China was the reform of SOEs. At the beginning of the reforms, SOEs dominated China's industrial sectors in every respect. SOEs share in total industrial output was 77.6% in 1978(Lin et.al,1998). Before the reform process started, SOEs were working as agents of the state economic bureaucracy. SOEs didn't enjoy autonomy or entrepreneurial freedom. The state provided all inputs to SOEs for their production according to central plans and covered all their costs. SOEs were supposed to deliver the state all output and revenues. State set wage rate of SOEs workers and managers and above all any activity of SOEs required the state's approval. The state interfered in almost all affairs of the SOEs. The managers in SOEs had limited authority over research and development, investment planning, marketing or even routine matters of production scheduling, material purchases, wage structures and employment levels (Jefferson and Rawaski,1996).

The focus of Chinese reform process has been to remove barriers to enterprise initiative. The reform of SOEs in China started in the form of reforming management systems so as to provide entrepreneurial freedom (Rawaski,1996).

Management reforms in China started with the introduction of Profit Retention Program. Under this programme, Government allowed SOEs to retain modest share of total profits. This program initially gave 12 percent of increased profits or reduced losses to the enterprises. The SOEs could use the retained income for paying bonus to workers, supporting welfare programmes, and investing in capacity expansion. Managers also obtained unprecedented control over any output beyond

mandatory plan targets. The managerial reform was gradually deepened through the introduction of contract responsibility system in which SOEs agreed to deliver pre-determined amounts of revenue to the state and retained the residuals. Under contract responsibility system, enterprise managers or a group of managers or sometimes the firm's entire workforce agree to fulfill specific obligations in return for excessive control over enterprise operations, including full or substantial retention of excess profits. The managerial reforms reached its highest level when the government replaced contract responsibility system by modern corporate system in which the state was entitled only the dividend on its shares in SOEs assets. Mody and Wang(1997), opines that China in the 1980's experienced an explosion of pent-up entrepreneurship facilities by wide ranging economic reforms. These pent-up entrepreneurs included not just factory managers but also local government officials, especially Mayors of Cities and Counties.

Meanwhile Government also introduced dual pricing system. Under this system, after fulfilling compulsory delivery obligations to the state, SOEs were allowed to sell their quota outputs to the markets at market-determined prices. The enterprises were also permitted to purchase inputs from the markets to increase production or to expand productive capacity. This system reinforced the management reforms by making available large quantities of industrial inputs in the market rather than through the administrative allocation system of the Government. The dual pricing system provided much more freedom to the managers. This system has created much competitive environment for the SOEs as compared to the pre-reform period.

Most immediate and direct effect of SOEs reform was managerial autonomy. The managers of SOEs gained almost full authority over decisions about the quantity and variety of output, production methods and selling price. Market supporting institutional developments such as creation of markets for industrial materials, opportunities to hire consultants, patent and copyright legislation, commercialization of scientific and technical research, growth of trade and professional associations, etc, also enhanced enterprise autonomy. However, state regulation continued in some areas.

When reform started in 1979 most of the SOEs were profitable. Lin et al(1998) have found that in spite of the significant increase in productivity, the profitability of SOEs has declined substantially during the reform period and currently more than 40 % of the SOEs are running at loss. This loss is despite large amounts of implicit subsidies as well as other policy protections provided by the government. The share of SOEs in the total industrial output has also reduced to 28.8% in 1996 as compared to 77.6% in 1978. The SOEs have remained technologically backward. They moped up nearly 90% of the loans granted to Chinese enterprises by state

owned banks. The wages of these SOEs have been consistently cut (Acharya, 1997). The SOEs still remain as a weak link in the whole reform process in China.

## Growth of Township and Village Enterprises (TVEs)

In the reform process China has made a shift in focus from SOEs to more market oriented institution like TVEs. TVEs are the most distinctive feature of Chinese transition and have become a major economic force. Presently about 31 percent of the industrial output comes from the TVEs (Harris, 2001). TVEs unlike SOEs have strong profit objectives, enjoy more operational autonomy and are relatively free from central and state bureaucracy compared to SOEs. Many studies have concluded that the TVE sector has been more efficient than SOE sector. In 1978, 1.5 million TVEs employed 28.2 million workers, whereas by 1996, 23.4 million TVEs employed 135.1 million workers (DaCosta, et.al 1999). The conditions existed before the start of reforms has helped the proliferation of TVEs, though the proliferation took place in the reform period only. The Maoist view of local self-sufficiency resulted in substantial decentralisation and specialization at the local level. Economic reforms further favored TVEs. Relaxation of State monopoly in several economic sectors and removal of barriers to entry enabled TVEs to engage in activities previously denied to them.

## Reforms in Foreign Trade and Investment

Economists in general believe that the driving force behind the international trade is the comparative advantage that the countries have in the production of various goods. In China, before the trade reforms, comparative advantage had never been looked into (Gerber, 1999). Before the start of trade reforms all imports and exports went through the foreign trade corporations. There were 12 Foreign Trade Corporations (FTCs) attached to various branches of the government. Imports were allowed only when domestic enterprises failed to fulfill the plan targets. The bank of China were to pay the foreign currency for imports and FTC were required to sell the foreign exchange which they earned through exports to the Bank of China. All imports and exports went according to the Central Plan.

Trade reforms in China saw the shift of production towards labour intensive assembling and processing units where they have comparative advantage. An important feature of trade reform is decentralisation of system of trade leading to opening of trade and reintegration of China into the world trading system. The trade reform process was started with the creation of additional FTCs in the hands of national, provincial and local authorities. The large SOEs were also given the

right to trade. In 1979 the leaders of Communist Party of China(CPC) came with an innovative idea of Special Economic Zones (SEZs). China set up three SEZs in 1979, one in 1980 and the fifth and last one in 1988. In SEZs special economic policies and special economic management systems were followed. China considered SEZs as windows and bridges to outside world. Foreign enterprises can see Chinese market through this window and Chinese firms looking out can see latest technology and world markets. SEZs can provide special incentives to form joint ventures and to set up production facilities. This would act as a bridge between China and the rest of the world.

Investment liberalization took place in China in the form of special tax concessions, liberalized leasing of land to foreign enterprises in coastal cities, foreign participation in property and port development, power generation and retailing. In 1995 service sectors like transportation and communication, insurance and other services have also been opened up (Bhalla and Nachne,1988). Foreign funded law and consultancy agencies are allowed to operate.

## Financial Sector Reforms

China's financial reform has been gradualist in nature without big changes at one stroke. It is possible to divide Chinese financial reforms into two periods: one between 1978 and 1993 and another after 1993 (D'acosta and Jeniffer, 1999). In the first period of the reform process the Central Bank was decentralized giving greater autonomy to its branches. Different forms of financial tools and institutions came up during this period. However, the establishment of stock exchanges in the early 1990's has been the most important event in the financial sector. The stock market was established in Shanghai and Shenzhen in 1990 and 1991 respectively.

In 1993, The Chinese government initiated more financial reforms in order to provide proper banking regulation and supervision to ensure accountability and risk management. More and more restrictions on local financial institutions imposed in their credit expansion in speculative investments. The post 1993 witnessed drastic banking reforms. The banking reforms included: i) recapitalisation of banks, ii) control of expansion of finance companies with bad track records, iii) reduction of branches of PBC and its reconstruction, iv) conversion of specialized state banks into commercial banks, and v) separation of commercial lending from policy lending, etc.. There has been significant changes in the foreign exchange sector also. In January 1994, dual exchange system was replaced by a unified rate in order to ensure a more efficient allocation of foreign exchange to different regions. The transition to unified exchange rate was quite smooth because of a gradual process of exchange rate adjustment and liberalization. The reforms also included

elimination of the foreign exchange quota retention system and the establishment of an inter-bank foreign exchange market.

Financial liberalization in China intended to build a financial system on the basis of market principles and decentralized decision making, has not yet gone far enough (Balla and Nachne, 1998). Banking reforms depend to large extent on the reforms in SOEs which have so far been very slow. PBC still continues to bail out SOEs by financing budget deficits under government instructions. Improving the performance of banking sector is a big task without accompanying reforms of SOEs and institutional and legal reforms.

### III. Economic Reforms and Economic Growth

Reforms have immensely helped China to boost its economic growth. The results of the reforms in terms of economic growth have been phenomenal. During 1980-89, the GDP grew at the rate of 10.1 percent per annum and the decade 1990-99 witnessed 10.7 percent growth per annum (Nair, 2002). The higher economic growth can be attributed to the higher productivity during the reform period. In 1979-94 period productivity growth became a significant force in driving the economy and accounted for about 42 percent of China's aggregate growth. The productivity growth during 1980-89 and 1990-99 was 4.2 percent and 6.2 percent respectively compared to 3 and 3.8 percent in India over the same period.

The market oriented reforms and increased integration into the world economy are the most probable explanations for the rapid productivity growth observed in China in recent years (Hu and Khan, 1997). There are certain specific factors, which contributed towards the productivity growth. Firstly, there has been a significant movement of labour from agriculture to industry and service sectors. Share of labour force in agricultural employment fell from more than 70 percent in 1978 to 54 percent in 1994. The shift of labour force into the manufacturing has been an important source of aggregate productivity growth for the economy. Secondly, the output of the non-state sector has risen dramatically over the past two decades. Its share has increased from 25 percent of the output in late 70's to 56 percent in 1994. The productivity in non-state sector grew more than twice as fast as the state sector on an average during the reform period. Thirdly, China could attract large amount of foreign direct investment (FDI) through its open door policy and Special Economic Zones. FDI into China was negligible prior to reforms. Now about \$40 billion FDI flows into China annually. Lastly, China has emerged as an export powerhouse over the last decade. Total exports as a share of national income rose from 6 percent in 1978 to over 30 percent in 1994. The ratio of trade to national output increased from a little over 10 percent in 1978 to 60 percent by 1994.

Exports increased from \$7 billion in 1979 to \$48 billion in 1988 and about \$ 70 billion today. The above factors individually and jointly contributed towards the productivity growth and thereby the economic growth in China.

#### IV. WTO Entry and Future Reforms

The future reforms in China would be in tune with the obligation and commitments it has made towards the entry into WTO. China has signed a new deal with US in November 1999 as a step towards its entry into WTO. The deal involves sweeping economic reforms in China. The new deal has been viewed as strategically a very important event. The deal, if made functional, will convert China's economy into fully functioning market economy. The significant aspects of the deal are: i) reduction of import duties from an average of 22.1 percent to 17 percent; ii) elimination of export subsidies; iii) 49 percent of foreign ownership in telecommunication firms immediately, rising to 50 percent after two years; iv) foreign banks would be able to conduct yuan business with Chinese firms two years after China's entry into WTO; v) China will establish large and tariff-rate quotas for wheat, corn, rice and cotton with substantial share reserved for private trade; vi) opening up of service sector, i.e., new access for US insurance companies as also for computer services, business consulting, accounting, advertising and financial information services; vii) US special "anti-import surge" rule will be phased out within 12 years of China's accession, special anti-dumping measures will be removed within 1.5 years and quotas on Chinese textile exports will end in 2005 (Acharya, 1999).

The impact of the deal will be felt more on SOEs, where the reforms couldn't make much inroads. Under the deal, the SOEs wouldn't be able to get protection in the form of high tariffs and other barriers. Joining WTO would force the state firms to restructure and abandon ailing and incompetent ones. It would result in a surge in job losses in SOEs which employ up to 60 percent of urban work force. Number of SOEs have expressed dissatisfaction with the new deal. Now for the first time state will have to withdraw its protection from these enterprises. New deal is a victory for the emerging capitalist class in China who have been arguing for deepening industrial reforms for a more radical reduction in the role of SOEs.

China has become the 143rd member of the WTO, ending a 15 year battle for accession to the world body. China will enjoy all the rights the WTO gives to other members and will observe the WTO regulations and its obligations to the organization. The accession document is about 1000 pages long containing China's obligations and commitments. List of obligations are so long. It encompasses all sectors of the economy. It is going to be a challenging task for China to fulfill the obligations set in the accession document. There is no much time left to meet the



obligations. In most cases the deadline set is 2005-06. The coming years thus contain a series of challenges for the present leadership. The economy appears to be slowing down, entry into WTO threaten to hit agriculture; liberalized industrial import could affect SOEs, expanding their debts to the point of bankruptcy (Harris,2001). Total economic liberalization without making social and political transition can be serious political challenge. If the people of China understand this as a light pain of injecting more reforms for the future growth, reform process would continue with a greater pace and higher economic growth.

## V. Lessons for India

To draw the lessons that India can learn from Chinese economic reforms, it is necessary to see the economic progress China has made during the reform period in comparison to India. A decade ago India and China had roughly the same per capita GDP. But at present, India's current per capita GDP approximately, \$450 is just the half of per capita GDP of China. China's economy is growing on an average at the rate of 8 to 10 percent per annum, while India's economy grows at a rate of just 5 to 6 percent per annum. In the post reform period, China's exports have gone up from 4% of GDP to about 25 percent of GDP. In India the exports were just 7.1% of GDP in 2000-01. In China, Industry's share of GDP rose to 50%. In India at present it is around 25 percent. China got so far \$400 billion as FDI. FDI for the last three years was \$114 billion, and over \$90 billion is expected to come in the next two years. China could bag an FDI of \$ 46.8 billion in the last year compared to India's \$ 2.3 billion. The rate of saving in China is 40 percent, while in India it is just 25 percent.

The above comparison reveals that India is far behind China in almost all-important economic fronts. The differences in performance can be attributed to the economic reforms initiated by China. Though little late, India also has started economic reforms. However, India couldn't make much progress as compared to China. In this context, India has to learn lot of lessons from the experience of China. Some of them are discussed below:

- i) India should lay emphasis on reforming agricultural sector as China did in the early stages of their reforms. Reform in agricultural sector is a key to industrial development. Market contribution, income contribution and factor contribution of agricultural sector are highly essential for industrial growth. Unfortunately, agricultural sector in India has remained almost untouched by the economic reforms.

- ii) Measures to attract FDI into India should be given utmost importance. One of the reasons for higher economic growth in China is high savings and investment. Savings in India is relatively low. We are in a vicious circle of low saving, low investment and low economic growth as compared to China. The way out here is to attract FDI. China even with high savings tried their level best to attract FDI on a larger scale and they have succeeded in that. In China, FDI has flown mostly into the Special Economic Zones (SEZs) because of high quality infrastructure in SEZs. Other reasons for high FDI are co-operative bureaucracy, speedy processing of foreign investment proposals, efficient and disciplined labour force. Till recently, India has not made sincere attempts to attract foreign investors. The proposal to set up SEZs in India in the recent Export-Import policy of government of India, should be given necessary support in attracting FDI.
- iii) India should speed up integration of the economy with the global economy removing restrictions and protection to the domestic industry. Any delay in this process will inevitable make Indian industries more inefficient and uncompetitive. China opened up its economy on a much faster and wider scale than India. China has become an export powerhouse. SEZs enabled China to export more. The export earnings have contributed greatly in improving domestic growth and employment. Imports also grew drastically over the reform period. Increase in trade has helped Chinese industry to become more efficient and competitive.
- iv) More and more liberalization is required in the industrial sector. India should accelerate the process of disinvestment in the public sector. In reforming SOEs, China also couldn't make much headway. However, reforms in the form of managerial autonomy have created a competitive environment for SOEs as compared to pre-reform period. What is needed in India is to fully free the public sector units from the centre and state bureaucracy and grant them more managerial autonomy. China's success in industrial growth during the reform period is mainly due to the progress made by the non-state sector. Therefore, it is also important to promote corporate sector by providing proper incentives.
- v) India should pay more attention towards developing the infrastructure. China's main advantage over India is the high quality infrastructure. India's infrastructure is relatively poor except in telecommunications. In most of the states in India, the generation and distribution of power is in a bad shape. Indian roads, railways, ports, etc, are yet to be improved. India should attract considerable private investments including FDI into these fields. The focus on infrastructure development in the last Union Budget assumes significance in this context.

- vi) India should not slow down the reform process on the ground that the rate of growth of the economy is slowing down. On the other hand, the reform process should be strengthened to improve the rate of growth of the economy. In China, last two years have witnessed slackening of economic growth compared to the last two decades. However, the reform process is not slowed down. In fact, the pace of economic reforms in China has increased due to its entry into WTO. India should also show the political will to continue the reform process facing the challenges.

## VI. Conclusion

The economic reforms in China have been successful in achieving the goal of higher economic growth. Managerial autonomy, decentralization of decision making, opening up of the economy are some of the highlights of the reform process. The reforms have covered almost all sectors of the economy. Reform process has helped China to achieve higher economic growth through the increase in productivity. Entry into WTO would help China to deepen the reform process. India has to improve the productivity and growth to catch up with China's economic growth. India has lot of lessons to learn from China's economic reforms. These lessons include reforming India's agricultural sector, measures to attract FDI, promotion of international trade, further liberalization of industrial sector, infrastructural investment, etc.. Government should learn these lessons seriously and acts upon that. What is needed at this time is that the government should push the second-generation reforms forward.

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