

Guoqiang Tian

## China's Reform: History, Logic and Future<sup>1</sup>

**Abstract** This paper is a brief introduction of the core content and basic concepts of the book *China's Reform: History, Logic and Future*, and gives answers to questions such as why China's reform and opening-up policy has achieved great success, why the catch-up mode, extensive and extractive development mode China adopted in the past three decades are no longer sustainable and what China's market-oriented reforms should aim to achieve in the next stage so that readers can have a profound understanding of China's reform. Planning ahead, from the perspective of sustainable economic development, China badly needs to transform from factor-driven growth to efficiency-driven and innovation-driven growth, the key to which is to further encourage the liberalization of thought, promote reform and opening-up, unswervingly follow the path of economic liberalization, marketization and privatization, to establish an inclusive modern market system, to allow the market to play a decisive role in resource allocation and the private economy to play a dominant role in the national economy. The market-oriented reform is a complicated project and China is faced with at least three different aspects of reform in some key areas—the main body of private economy, the liberalization of financial market and the marketization of land. Meanwhile, China needs to efficiently balance three elements of good governance, that is, the rule of law, execution and democratic supervision, so as to facilitate the modernization of

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<sup>1</sup> The paper is condensed and adapted based mainly on the introduction part of *China's Reform: History, Logic and Future*, a monograph by Guoqiang Tian and Xudong Chen which won the 16<sup>th</sup> Sun Yefang Prize in Economic Science (the top prize in China's economics field). It summarizes and introduces core content and basic propositions of the book, and provides a new interpretation of China's current reform and development status.

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Guoqiang Tian (✉)

School of Economics and Institute for Advanced Research, Shanghai University of Finance and Economics (SUFU), Shanghai 200433, China; Department of Economics, Texas A&M University, College Station, TX 77843, USA

E-mail: gtian@tamu.edu

state governance system and governance capability.

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*Deng (Xiaoping) opened the front door of a central country. This is a magnificent feat in human history!*

*Time, January 1979*

The strategic decision and practical exploration of the reform and opening-up policy initiated by Deng Xiaoping in 1978 has led China onto a developing and rejuvenating path featured by economic marketization and opening-up, ushering in an era of prosperity that China had not experienced for over 170 years. Although other Asian countries or regions also enjoyed similar growth in the 1960s to 1980s, it is an unprecedented achievement for China. For an economy with a population of more than one billion, it has managed to sustain growth of nearly 10% for more than 3 decades and lift 500 million people out of poverty, a population size approaching that of the EU. In the meantime, China has achieved steady transformation from a monolithic planned economy to a modern market economic system, with the proportion of gross industrial output value of the non-state-owned economy growing from 8.78% at the beginning of the reform to over 80%; the non-state-owned economy has become the major impetus for China's economic growth.

China leads the world in many economic indicators and has become a critically important force in global political and economic patterns. However, although the framework of market economy system has taken shape in China, there is still a long way to go before a modern market economic system (system where the market fully plays a decisive role in allocation of resources) is established. Currently the government and state-owned enterprises still have a dominant role in allocation of resources, which seriously limits and suppresses the role of the market. Such an extractive system of semi-market and semi-control (where the market only has a limited say in how it operates) has resulted in two extremes: While we have witnessed great development in China since the reform and opening-up (e.g., high-speed economic development), it has been coupled with severe problems (e.g., rampant corruption and insufficient

social fairness and justice); social and economic development is increasingly unsustainable. Ultimately, the underlying reasons for these problems are institutional flaws, which are key and decisive, including a lack of depth in market-oriented reform, an unsound market economic system and failure to reasonably define and clarify the governance boundaries between government and market as well as government and society. To be specific, government-leading economic development and social governance model give rise to the “overplay,” “underplay” and “misplay” of the government role. Such dominance by the government and monopoly of state-owned enterprises will certainly lead to inefficiency, rampant corruption, pressure on the private economy, harm to innovation and unequal opportunities.

As a prominent manifestation of unsustainability, China’s economy is now faced with unprecedented pressure of an impending slowdown. Annual GDP growth has gradually decreased to 9.2%, 7.8%, 7.7% and 7.4% respectively since 2011 and to 7% in the first half of 2015; the figure will probably decrease even further and it will be accompanied with the risk of increased deflation. The main reasons for this remarkable slowdown in China’s economic growth in recent years include decreasing factor-driven dividends, lessening government-led impetus and catch-up economic development mode in which the private economy is squeezed by excess capacity of state-owned enterprises. This causes exhausted economic growth momentum, industrial monopoly, government liabilities, excess capacity, inefficiency, underdevelopment of the private economy, low competitiveness of enterprises, rich country but poor people, rampant corruption, corrupt consumption, weak private consumption and other prominent problems, all of which will result in an unsustainable economy. The inaction of government officials and their misunderstanding of the “new normal” economy also contribute to the slowdown. The problems in China’s economic development cannot be linked to economic reasons only, as they have much to do with the delay in political, social, cultural and ecological reforms. In brief, they are the result of the delay in an all-round comprehensive reform and the failure to establish an inclusive institutional arrangement.

The key to the aforementioned problems is a decisive institution, together with comprehensive reforms in economy, politics, society, culture and ecology. To achieve sound and fast sustainable economic development and lasting political stability, it is critical for China to have a good understanding of the logic of

development and governance, to find a good balance between the two and establish more inclusive institutional arrangements. Modern market system is irreplaceable and the market should play a basic and decisive role, so the main concern is what the role of the government should be. Unless there is market failure or crisis, the government should not interfere, but maintain and serve the market. Only by rationally defining the governance boundaries between government and market as well as government and society with each performing its own intended function in an interactive and complementary manner can China achieve steady development.

This is supposed to be the rationale behind China's deepening reform for the next stage; however, due to ideological differences or conflicts of interest, not everyone agrees, making future reform a very tough task. Therefore, reform requires not only theoretical guidance, but also a good methodology. The book *China's Reform: History, Logic and Future* has two main purposes: one is to "clarify" the method to reform and maintain prolonged stability in China; the other is to "optimize such a method," that is, to envisage the arduousness of reform, make good use of reform methodology and implement good mechanisms for reform. Both are indispensable.

Joseph A. Schumpeter regards that scientific economic analysis involves history, statistics, and economic theory.<sup>2</sup> The difference between an economic "scientist" and a common economist lies in whether these three elements are employed in his economic analysis. When writing this book, we have realized that research on China's reform requires an organic combination of the three elements, since only in this way can our economic analysis be more profound and insightful. Thus we make in this book a systematic collation and summary of the formation, inherent logic and future trend of China's reform path through internal logical analysis of economic theories, especially the core concept of mechanism design theory on information efficiency and incentive compatibility by reference to the long history over the past 170 plus years as well as the vertical and horizontal comparison with international cases, so as to provide more perspectives and views for the modernization of state governance system and governance capability in the new era.

This paper, extracting the core content from the book, mainly answers three

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<sup>2</sup> Schumpeter, Joseph A, "Science and Ideology" in Daniel M. Hausman, eds., *The Philosophy of Economics*, Cambridge: Cambridge University Press, 1984, pp. 260-275.

questions: why has China made great achievements in economic reform in the past? Why is catch-up development mode no longer sustainable? What should China's market-oriented reform aim to achieve in the next stage? It provides readers with a clear and profound understanding of the history, logic and future of China's reform.

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## **1 Retrospective Look on History: Why Has China Made Great Achievements in Economic Reform?**

China has undergone four critical turning points since the modern times: the Opium War in 1840, the Revolution of 1911, the founding of the People's Republic of China in 1949 and implementation of the reform and opening-up policy in 1978. Undoubtedly, it was the reform and opening-up initiated by Deng Xiaoping that pulled China out of poverty, backwardness and self-seclusion and brought about great developmental achievements. Any reform requires three basic elements: initial conditions, target pattern and evolution mode. Judging from these requirements, a review of China's reform over the past three decades can give us a glimpse of both the uniqueness and the universality of China's reform as compared with other transition economies.

Firstly, in terms of the initial conditions, the basic background of China's reform and development in 1978 was that inefficiency in the centralized planned economic system due to information asymmetry and incentive distortion was fully exposed while the defects of the Soviet economic model were not materially corrected by administrative decentralization. Besides, the "Great Cultural Revolution" caused such severe damage to China's economy that the national economy was brought to the verge of bankruptcy. Despite the restorative growth in 1977 and 1978, it was impossible for China to notably change the status of being poor and weak in the short run. With national income per capita being around USD 300 only, China was one of the poorest countries in the world in 1978. A consensus was thus reached on the necessity and urgency of reform.

Secondly, in terms of the target pattern of the reform, under the influence of the traditional culture, ideology and concept of planned economy, the whole nation knew little about the modern market economy, in addition to the fact that there was no precedent to follow, so China, at the beginning of its reform in 1978, took a strategy of "wading the river by groping for stones" and followed a pragmatic philosophy that "cats, no matter black or white, are good if they can

catch mice". At that time, neither the target nor the roadmap of reform was clear for China. As reform deepened, China gradually adjusted its economic reform from planned economy to planned commodity economy and further to socialist market economy. It differs greatly from the Soviet Union and Eastern European countries, especially Russia, which adopted "radical therapy" during the late 1980s to early 1990s and had a clear target of establishing a well-functioning market economy at the very beginning of their reform.

Thirdly, in terms of the evolution mode of reform, China's reform path in 1978 had two basic characteristics: first, economic centralism and single economic reform. They have played an important role in China's governance philosophy over a very long time and remain important even today; second, the gradualness of the reform. The reform in China involved a series of stepwise and gradual changes focusing on economic reform, as opposed to the explosive and radical reform of shock therapy adopted by the Soviet Union and Eastern European countries which involved tremendous changes in politics, economy and society. Both basic characteristics were greatly related to the aforementioned poor initial economic development conditions, so they were justified and inherently logical at the beginning of reform considering the urgency of economic development and of the need to avoid a possible dramatic economic downturn. At that time, China only had a per capita national income of \$300 and it was of utmost urgency to boost economic development and improve people's livelihood. In case of a drastic economic downturn, it would have caused social unrest as the average people would have been unable to withstand it.

When comparing the radical and gradual reform paths, we cannot simply adopt the all-or-nothing thinking. Under respective basic initial political, economic, social and cultural conditions, the so-called optimal choice is relative. China's gradual reform and single economic reform strategy did, to some extent, ease social disorder and instability which might have occurred had we launched a radical reform. It, however, led to the accumulation of many problems and contradictions, of which many people involved were totally unaware. In contrast, although the radical reform in Russia failed to bring about economic growth as remarkable as that in China and caused serious social problems and economic upheaval in the short term, the orderly overall reform helped to lay down an initial institutional framework conducive to long-term development. Radical reform was not as bad as previously imagined, since Russia developed well in

various aspects, including people's livelihood, and has become a high-income country since 2012. That being said, Russia still has a way to go in their transition and transformation.

In conclusion, realistic concerns for China's reform include a one-step overall systematic reform plan made impossible by poor initial economic endowments, low wealth level and limited availability of resources, as well as the delay in the consensus and implementation of the development goals of a modern society—democratic politics, rule of law and market economy due to the influence of traditional Chinese culture and severely distorted social development under the planned economy. Consequently, China took a transition path which prioritized economic reform by learning through trial and error, experiments and pilot projects. Then, what is the root cause for great achievements in China's reform and development? Are the economic reform policies and measures China-specific? The answer is negative. Despite its particularity, China's reform and development follow universal rationale and can be interpreted and guided by modern economic theories.

The reason why China has made such great achievements in its reform is that it has implemented a market-oriented reform which focuses on opening-up and decentralization. In a context where the country is gradually opening to and compatible with the international community, those in power take full account of two major realistic constraints, i.e., limited ideological consciousness of the masses and a high degree of information asymmetry, as well as meeting the four prerequisites for any well-functioning economic mechanism: the acknowledgement of individual interests, individual rights that guarantee economic freedom, decentralized decision-making, and the implementation of incentive compatible mechanisms. This has fully aroused individual enthusiasm and motility, and effectively solved the problems of information asymmetry and addressed the lack of incentive, so that the basic role of market in resource allocation could be gradually established and promoted. All these reflect the inherent logic of economics, which is the common experience repeatedly verified by East Asian and even developed Western countries. Additionally, China has also implemented decentralization of local governments to encourage regional competition and adopted steady transformation through a gradual reform system; especially, it has properly handled the relationship between reform, development and stability: reform under stable conditions boosts development while

development brings continuous benefits to the individuals (meeting and continuously relaxing participation constraints) and in turn promotes stability, thus creating favorable conditions for intensifying reform and propelling further economic growth.

A retrospective look at the dynamic evolution of China's economic reform over the past three decades reveals that although the reform is market-oriented, the pattern of "big government and small market" remains unchanged due to the fact that the market grows out of nothing. Similar to the growth of a child, the nurture, guidance and help (sometimes even interference) from the parents are necessary in the child's babyhood. However, as the child grows up, parents' guidance and interference should decrease gradually, so that the child can become more independent. This is the current state of China's economy and the constraint from government should be gradually relieved. Market, not the government, should play the leading role in economic development. This should become the target of China's further reform.

Nevertheless, due to the enormous energy and momentum generated by market-oriented reform and opening-up, despite huge internal and external resistance and friction, it has had far more positive effects than negative effects during the transition, including those negative impacts brought by government-led economic development and social governance. As a result, there are some people with short-term thinking or vested interests who mistake resistance as impetus and wish to put an end to any form of progressive thought. For instance, they owe the success of China's reform to its government-led economic development path, social governance mode and political administrative structure, and overstress the role of the government and believe it is a relatively stable and mature ultimate development "China model" which rivals its counterparts of the developed Western countries. This "fatal conceit" is definitely not true and they have mistaken "the suboptimal" as "the optimal" and taken a transitional, extensive and extractive institutional arrangement as the ultimate one. Therefore, the policy they advocate focuses on the weakening of reform featuring opening-up and decentralization, and a greater role for the government in shaping the economy. This threatens to undermine the reform in the next step and long-term orientation of reform and opening-up, about which we should be vigilant.



## 2 Logic Reflection: Why Is Catch-up Development Mode No Longer Sustainable?

Though the existing development mode has brought China impressive economic achievements in the past 30 years, it is a catch-up and transitional mode that is unsustainable in the long term. The transition from factor-driven to efficiency-driven and innovation-driven development must be achieved for the next stage of reform. The best proof of that is the slowdown of China's economy in recent years. With a strong global economy and stable domestic political and economic situation, what is the cause for the continuous downturn? Is this continuous rapid decrease in the economic growth rate really going to be a feature of "new normal" caused by a sharp slowdown of potential growth rate? There is no doubt that China's economic growth has slowed due to the objective economic law of diminishing factor returns. However, the downturn is at a rate a lot worse than previously expected.

If we merely point out the symptoms and measures to be taken, but fail to identify the root causes of this downturn and address these problems at a fundamental institutional level, then we can only rely on temporary stopgaps. Our analysis shows that, while there are periodic reasons for the continuous downturn of China's economy at present, the problem lies mostly in China's economic structure, such as the industrial upgrading and transformation of industrial structure and demand. In addition to these two reasons, China is also challenged by the delay in the dual transition of development dynamics and the economic system, which is the more critical root cause for its economic growth not reaching its potential.

Specifically, as factor-driven dividends decrease, the purely factor-driven economic development mode where the government and state-owned enterprises play a major and dominant role is no longer sustainable, in addition to serious inaction during government administration and misunderstanding of the "new normal". These are the five reasons for China's economic downturn, while the more fundamental causes include lack of depth in market-oriented reform, poorly-defined governance boundaries between government, market and society, and an unsound market economic system, specifically as follows.

**Firstly, factor-driven dividends decrease and growth slows down.** It is true that the factor-driven development mode contributed a lot to China's economic growth for quite a long time in the past. However, in the long run, due to the

objective economic law of diminishing marginal returns, cost of factors will continuously rise as the growth of productivity decreases, so the factor-driven development mode is unsustainable. Such a mode is an extensive economic development mode which leads to high input, high energy consumption, high emission, high pollution, low economic benefit, low labor returns and low added value of innovation, as the factor-driven mode itself is unreasonable although it can effectively bring competitive advantages during a certain period of time when the factor price is forced down through non-market behavior on an underdeveloped factor market. As factor dividends such as demographic dividends, resource dividends and environmental dividends decrease, along with sustained external pressure such as the appreciation of the RMB, high international trade barriers and the rise of other emerging economies, this development mode is obviously unable to continue pushing China to become a high-income country.

It should be noted that due to regional differences, uneven levels of individual productivity and the gradual nature of the transition of economic development driving force, we should not depend on the “one size fits all” method or expect the transition to be achieved overnight. Owing to an unclear understanding of this transition and the misinterpretation that transition from factor-driven growth to efficiency-driven and innovation-driven growth would mean that factors should completely fall out of use, many local governments forced some industries to transfer actively or passively to some Southeast Asian countries by hastily “emptying the cage to change the bird” and “replacing laborers with robots”. This is probably another major reason for the dramatic downturn in China's economic growth. As a matter of fact, the transition from factor-driven growth to efficiency-driven and innovation-driven growth is not a simple unidirectional substitution; instead, it reflects a shift in the dominating driving force, the later stage of which should be based on high development in the former stage as well, with original driving factors still playing an important role as stock and overlap. Otherwise, falling between two stools will also disable economic growth.

Even with the justifiable slowdown in China's economic growth and potential growth rate due to the economic law of diminishing factor returns, the downturn is not supposed to be so severe. Putting aside possible reform dividends resulting from institutional improvement brought by the deepening of reform and

strengthened governance, and judging from medium- to long-term outlook such as labor force, capital and total factor productivity, China shows no dramatic decline in its potential economic growth rate, which is expected to remain 7% or above in five to eight years. Of course, the authors are not as optimistic as some scholars who believe that China's economic growth rate can reach 7% and even 8% in the coming 20 years. The only way this figure might be achieved would be by extensive development with consuming resources and jeopardizing the ecological environment, while the cost in the long run would be very high.

**Secondly, government-leading motivation has been exhausted, with lack of public service function and deficient endogenous growth.** China is still a government-led market economy; in the past, local government officials were provided attractive incentives to stimulate economic growth while their promotion was mainly based on their political achievements in boosting local GDP growth. The fiscal system of China was featured by “multiple threads from the central government and only one needle at local governments” after the 1994 tax reform, indicating a mismatch between the financial resources and the administrative power of local governments. Land bidding and reform of the housing system in 1997 remolded China's development mode; due to monopolistic supply in the land market, the land finance of “making money from land” and local mortgage loans became important fiscal measures for local governments. Therefore, in the context of urbanization, circulation of land between urban and rural areas became a major impetus for China's economic growth over the past 20 years, which served as an “accelerator” to some extent. However, a large number of problems occur in the process, in the shape of violent demolitions, ecological disturbances, destruction of historical sites and cultural relics damage, resulting in a series of social contradictions.

It is also a vicious circle for the government itself. On the one hand, the government, by virtue of monopolistic land expropriation rights, forms a new financing channel based on land mortgage. During 2007–2013, land mortgage area in 84 key cities increased from 1,925,000 *mu* (1 *mu* = 666.7 m<sup>2</sup>) to 6,059,000 *mu*, with mortgage loans increasing from 1.33 trillion yuan to 7.76 trillion yuan. Leveraged by finance and capital, China's economy enjoyed high-speed growth, but during this process the leverage became too high and the bubbles too severe. On the other hand, these mortgage loans, including other local government debts, are mostly repaid through land leasing revenues,

providing a big incentive for local governments to strengthen land finance. In 2014, local gross land revenues accounted for 56.2% of the general public budget revenues at the local governments. In case of large fluctuations in the land market, the non-performing loan ratio on the financing platform of local governments might rise rapidly, which indicates huge local debts and financial risks. Thus, it is unsustainable and drains the impetus for government-led economic development.

Meanwhile, a predominantly development-driven government with a lack of service functions also results in weak consumer willingness and consumption capacity. The government still plays a dominant role in fields where the market should play a decisive role in allocation of resources, and becomes an agent of interest on the market, limiting the opportunities for people to enjoy market incentive revenues. Government finance focuses too much on fixed-asset investment, administrative expenditure and “three public consumptions” (i.e., expenses on vehicle purchasing and maintenance, overseas trips and official receptions), but too little on public services and social security. A severe undersupply and imbalance of basic public products has led to too much precautionary savings and weak consumption, making it impossible to form genuine endogenous developing dynamics. In 2014, China's household consumption accounted for only about 38% of GDP, less than half of that in America and lagging behind Russia's figure of 55%. Sustainable economic development requires China to transform from a producer society to a consumer society and this will be a gradual process.

**Thirdly, state-owned enterprises, with excess capacity, squeeze the private economy and impair economic vitality.** Even today, the state-owned economy still has a large scale and the monopoly of state-owned enterprises in some areas and important industries is still growing. The economic growth data in various provinces in the first half of 2015 reveals that provinces with a greater proportion of state-owned economy and less developed private economy tend to undergo a more rapid slowdown. For example, Liaoning, a northeastern province, had a growth rate of only 2.6%, while Heilongjiang and Jilin, the other two provinces in northeastern China, also ranked among the poorest. They all fell out of reasonable economic growth range. By comparison, areas with a more developed private economy, such as Zhejiang and Guangdong, suffered smaller decreases in economic growth. In areas with a larger proportion of state-owned enterprises,

state-owned enterprises always occupy too many factors since they control resources and energy and have privileged access to financial resources, while medium-sized, small- and micro-sized private enterprises in these areas are faced with tougher conditions when it comes to financing and high production costs than those in other areas and suffer severe barriers to development. In this sense, the market in those areas lacks a benign competitive mechanism, thus impairing economic vitality.

A considerable amount of money from the central “four trillion yuan” economic stimulus package in 2008 flew into state-owned enterprises which already had abundant funds, giving rise to continuous accumulation of repeated and inefficient investment as well as insufficient economic stimulus mechanisms. According to the National Bureau of Statistics of China, multipurpose utilization rate of the capacity of China’s industrial enterprises stood at lower than 80% at the end of 2013, which further declined in the past one or two years, with some industries having become absolute surplus industries. For example, in the iron and steel industry, China currently has an annual crude steel capacity equivalent of 1.2 billion tons; roughly speaking, annual capacity utilization rate is less than 70% according to crude steel output in the first half of 2015. This is just the tip of the iceberg, since many other industries in China also suffer from excess capacity. In the coal, electrolytic aluminum, cement, sheet glass and shipbuilding industries, excess capacity are all at over 30%, bringing about a dramatic decline in industrial profits. All these are the results of a vicious repeated cycle of stimulating growth with growth and producing resources with resources which eventually leads to high excess capacity and large-scale losses for enterprises. In addition, local governments closely followed the revival program for seven strategic and emerging industries (which was later on expanded to nine industries) proposed by the central government in 2009. With fiscal subsidies from and technical roadmap assigned by the government, many strategic and emerging industries such as wind power equipment, polycrystalline silicon and photovoltaic cell rushed headlong into mass action, causing severe excess capacity as well. If the excess capacity is not solved in a timely and proper manner, the risk of deflation will further rise, aggravating the economic downturn.

A government-led economy with monopoly of state-owned enterprises results not only in excess capacity and low efficiency, but also in rampant corruption,

vigorous corrupt consumption and weak private consumption. To be fair, corrupt and extravagant consumption of government sectors and the boom of related industries used to be a major driving force of China's economic growth over quite a long time; however, it was abnormal consumption. After the enactment and enforcement of the "eight-point regulation"<sup>3</sup> and the "fifteen prohibitions", many flashy, high-profit and high-end consumer industries were beaten down. For example, overproduction occurred in high-end hotels, restaurants, clubs, food, costumes, cosmetics, nutrition, silver and gold, jewelries, pearl and agate, antiques, calligraphy and paintings, and consumer demand decreased, which also affected other relevant industries.

**Fourthly, the government itself lacks management by objectives and commits serious dereliction of duty.** The new central collective leadership has noticed the severity of corruption and warned that it would ruin the party and even the nation, so no efforts have been spared to combat corruption and build a clean government. It is undoubtedly an essential and timely decision that will serve to rectify the misbehaviors of officials, purify the administrative style, restrict power and improve the overall management of the party. China is still a government-led economy rather than one where the market plays a decisive role, while there is no sound market system as required for the transition. China's economy, despite its recent transformation, is to a large extent still defined by "preference to the government, state-owned enterprises and a wealthy country over the market, private enterprises and rich people respectively" and there is still a long way to go in its reform in streamlining administration and decentralization. Under these circumstances, if importance is only attached to anti-corruption efforts but the management by objectives is neglected, there will be a high degree of inaction (including policy inaction and executive inaction) and a common occurrence of the "three difficulties" (i.e., "difficulties in bank loaning, use of financial funds and obtaining various approvals").

Up to now the government is still closely involved in economic activities, the market still fails to play a decisive role and the relationship between politics and business is still inseparable, where firms are still subject to the government for "managing projects and obtaining approvals." At present, government officials at all levels set up a large number of approval procedures, project approvals and

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<sup>3</sup> See more details at: [http://cpcchina.chinadaily.com.cn/2012-12/05/content\\_15991171.htm](http://cpcchina.chinadaily.com.cn/2012-12/05/content_15991171.htm)

access barriers for economic activities. There is still a long way to go before a maintenance- and service-oriented, limited and effective government is established, so working efficiency of different government sectors (no matter whether they should take part) becomes an important factor in influencing development, including economic development. Once the working enthusiasm of government officials is affected, growth impetus will be impaired, and the downturn of economic growth will be further aggravated. Failure in China's economic growth to reach the expected goal in 2014, further downturn of economic growth in the first half of 2015 as well as low working efficiency and inaction caused by a lack of management by economic objectives directly widened the gap between actual and potential economic growth rates in China.

**Fifthly, there is a misunderstanding of “new normal.”** “New normal” means new achievements have to be made in order to improve market efficiency, social fairness and justice, stability and orderly management so as to maintain a medium-high growth rate for China's economy which is currently in ascension (which has not entered into balanced growth) as high-speed growth supported by extensive development such as high investment, high consumption and high pollution is unsustainable. Consequently, abandoning the “old normal” of extensive rapid growth, advocating streamlined administration, decentralization and keeping the government's power in check should by no means be equal to inaction or indifference towards the economic slowdown. Nor should it be viewed as a drastic decline of economic growth which eventually leads to a lack of firm commitment to and fulfillment of economic growth goals. If we do not clear up such misunderstanding and continue to be tolerant of such practice, it is highly likely that China's actual economic growth rate will further decrease sharply, judging from the current rate of decline.

The aforementioned five reasons result in the rapid and dramatic decline of China's economic growth, all of which are attributable to institutional reasons; after all, the root cause of the problem is that market-oriented reform is not thorough enough up to now, which serves as a stark reminder that the existence of reasonable institutional arrangements can be of crucial importance. Different institutional arrangements will bring about different responses to incentives, different trade-offs and consequently the results will be varied. China's economy has a very low efficiency due to the fact that the modern market system is not yet established, let alone innovation-driven growth based on the private economy; if

no counter-measures are taken in a timely manner, the possibility for China falling into the “middle-income trap” will increase exponentially. If these problems are solved, together with the improvement in executive efficiency and administrative efficacy, it is absolutely possible for China to maintain medium-high economic growth in the coming five to eight years.

Certainly, dramatic economic slowdown and imbalanced, unsustainable development are just a part of the structural problems in China; delays in political, social, cultural and ecological system reforms are also an important influencing factor and result in many deep-seated contradictions and problems, such as excessive interference of public power in the market which causes rampant rent-seeking and corruption, as well as a widening gap between the rich and the poor, wealthy and powerful country but poor livelihood of the populace, advancing state sector but retreating private sector, and insufficient domestic demand; inequality of opportunity which causes a huge wealth gap, lack of social mobility and great rifts among different social strata; serious distortion of social ethics and morals as well as humanistic value system under the impact of economic interest; frequent medical health and food safety crises; serious haze, a damaged ecology, deteriorating and endangered environment, frequent environmental mass incidents; lack of social fairness and justice. Social issues and contradictions in China are reaching a critical point and in urgent need of reform.

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### **3 Looking into the Future: What Should China Aim to Achieve for the Next Stage of Market-Oriented Reform?**

The most important keywords in the great achievements in China's reform over the past 30-plus years are “opening up” externally and “lifting the control” internally. Looking into the future, there is still quite a long way for China to go in these two aspects and the modern market economy system is set to play a crucial role in China's future progress. A complete transformation of China's economy requires intensifying market-oriented reform (instead of relying solely on economic reform), breaking through the barriers of interest solidification and getting rid of the obstacles and interference from special interest groups. By so doing China will usher in an all-round, comprehensive reform in the economy, politics, society, culture and ecological civilization, providing institutional support for the government to push through with market-oriented economic



reform. Until further progress is made, the market will not be able to play a decisive role in the allocation of resources; the transition and reconstruction of the driving force for economic development will be impossible. However, the market-oriented reform is a complicated project; for the next stage of reform, China should prioritize the following three aspects: the main body of private economy, the liberalization of financial market and the marketization of land.

The three points are also related to the main line of how the government and the market should function in allocation of resources respectively, which involves a reasonable definition of the governance boundaries between the government and the market. The message is to deepen the market-oriented reform and to limit the fundamental role and function of the government to “maintenance” and “service” as much as possible. That is, the government is supposed to make basic rules and regulations, guarantee social stability and provide public goods and services, while the decisive role of the market is supposed to be in full play in the allocation of resources, so as to facilitate China’s transformation from a government-led economy to a market-determined economy and lay an institutional foundation for China’s transition from factor-driven to efficiency-driven and innovation-driven growth.

**Firstly, the main body of private economy.** The private economy should play a major role and have dominance in areas such as job creation, contribution of production value, innovation, etc. China’s economic development since reform and opening-up, whether it be in production value or employment, relies mostly on the development of non-state-owned economy, especially the private economy, rather than the state-owned economy. The more developed the private economy is, the less troubles local governments will have, in both economic development and social stability. As previously mentioned, all economies will eventually upgrade from factor-driven growth to efficiency-driven growth, where the market will play a decisive role. The next step would be innovation-driven growth, where the private economy can play a dominant role. If innovation-driven growth cannot be achieved, a qualitative leap in China’s economic growth will be impossible.

**Secondly, liberalization of financial market.** Sustainable long-term development of China’s economy cannot be achieved without financial reform. Currently, China’s financial market is still a state-owned monopoly market with excessive government regulation and interference as well as strong barriers to

entry, resulting in the distortion of the allocation of financial resources and blocked passageway for finance to the real economy. This can be solved by interest rate liberalization and coordinated reforms in further deepening of the capital market, which allow the market to price funds with different time limits and risk characteristics and help to establish multi-level market structures with diversified investors and investments. Consequently, aims of the reform of the financial system for the next stage should include: forming a financial market with sufficient extent and depth, vigorously boosting the development of non-state-owned and private financial institutions, increasing the number of categories of financial products and portfolio selections, raising efficiency to allocate financial resources, promoting finance to better serve the real economy, and especially, strengthening support for medium-sized, small and micro-sized private enterprises.

**Thirdly, marketization of land.** Urbanization remains an important impetus for China's economic development. It is necessary to meet the prerequisite for urbanization in order for the transition into a market-oriented and open urbanization path, i.e., allocation of land by real land market. People without fixed properties tend to be in an unstable state; in addition, since land cannot develop into scale economy, the production cost and price of Chinese agricultural products keep going up and thus there is a huge and widening gap between the grain price at home and abroad, indicating that China's land system has big problems and risks. Through establishing an open and inclusive land market, the market can play a more important role in allocation of land resources, there can be free transfer of land between peasant households and between urban and rural areas, and the masses (especially farmers) can enjoy more land dividends. This will lay a firm foundation for China's economic and social development. Market-oriented reform of land means that local governments will have to obtain a large part of their budget revenues from other channels. As international common practice indicates, taxes in real estate development and sales can be integrated into or added to annually levied real estate property tax. On the one hand, an increase in the cost of holding real estate can encourage investors to put houses on the leasing market and second-hand housing market, so that houses can become real commodities and the high vacancy rate can go down. On the other hand, this tax can be used to adjust distribution of social wealth and bridge the income gap.

Once the basic system, reform direction and fundamental policy are determined, the next step will be to implement concrete measures, regardless of whether the governance boundaries between government and market as well as government and society are reasonably defined. No direction has been given yet on how to translate the overall goal of modernization of state governance system and governance capacity into concrete actions of the reform and development, which imposes new and higher requirements on the governance capacity of the government. As the government is both a major driving force for and a target of the reform, vested interests will inevitably complicate the whole process. As such, how to organically combine the two aspects and deepen the reform in an all-round way? In other words, how can we start with reform of the government and enable it to be a reform engine? How to ensure the success of deepening market-oriented reform? How to avoid damaging side effects on development when reinforcing the governance? These problems have much to do with the governance by government itself. In our opinion, good governance of a government can be achieved through three elements: rule of law, execution and democratic supervision.

Firstly, a sound environment of rule of law should be created. Rule of law refers to the regulation and restriction of government behavior in the first place and then the regulation and restriction of the market economic entities. This is the essential distinction between “rule of law” and “legal system.” A good environment of rule of law can support and improve the market, and allow the market to truly play a fundamental and decisive role while the government focuses on maintenance and service. Only in this way can rent-seeking and corruption be kept in check. In modern society, clarity and protection of property rights requires the guarantee from law. The essence of the market is “governance by non-interference” and the prerequisite for such a market is that it is effective; the essential condition to make the market effective is to have an effective government which is limited and well-positioned first of all. The positioning of the government should be regulated, orderly and institutionalized through rule of law. Therefore, the transformation from an omnipotent government with too much power to a limited one that has less control is crucial.

Meanwhile, to promote reform, sound rule of law must be implemented. Temporarily adjusting the short-term policy instead of touching on the fundamental articles and clauses which contradict universal law might make it

hard to push forward with the reform in the real sense, as policy announcements are quite likely to be misunderstood or even reversely interpreted by interested departments or individuals according to their own understandings or concepts. In reality, reform of the land system after the Third Plenary Session of the 18<sup>th</sup> Central Committee of the CPC encountered many twists and turns due to the misunderstandings of some departments and individuals. Hence, people who are fundamentally opposed to the reform, especially those who wield great influence and have public power, should be regulated and restrained by the rule of law and legally prevented from hindering the intensifying reform process.

Secondly, state capacity building should be strengthened. Good governance cannot be separated from government's execution, i.e., the so-called state capacity. Market economy does not mean anarchy; it requires a limited yet effective government which should execute basic functions such as maintenance and service. Failure to accomplish these two functions would be inaction on their part. Surely, both of the functions should be performed through public goods and services. As public goods have externalities that differ in scope of benefit or influence, optimum allocation of administrative and financial powers between the central and local governments is required. In other words, local administrative and financial powers should not be subject to too many restrictions, otherwise "decrees from the central government will remain effective only in Zhongnanhai (the central headquarters for the State Council)," and policies cannot be truly implemented by local governments.

Moreover, as the plan for comprehensively deepening the reform has been made, the next step is for this plan to be executed and implemented by local governments at all levels, by leaders and cadres. Especially in the context of today's government-led economy, execution is of crucial importance. Quite a few grass-roots cadres are afraid of making mistakes and taking responsibilities, so inaction on the government part has become a severe obstacle for the advancement of the reform. Reform execution and development impetus must be strengthened in three areas: rule of law, incentives and concepts. In particular, we need to discover and cultivate pioneering officials for reform and development. To this end, great efforts should be made in appointing cadre talents who are open-minded, brave and good at making innovations and carrying forward reform. Those who don't just follow the book or authority but are realistic and courageous to blaze a trail should be put on important or leadership positions, so

that they can push forward the reform process. In the 1980s, China witnessed a batch of go-getters good at promoting reform in relevant fields and regions, who were direct impellers of reform and later became the leaders of national reform. Among them were Hu Yaobang from ministries and commissions, Zhao Ziyang from Sichuan, Wan Li from Anhui and Xi Zhongxun from Guangdong province. Each was previously a reform go-getter in their respective jurisdictions and then assumed more significant reform tasks in the central collective leadership.

Thirdly, democratic supervision mechanisms should be improved. A government governance system without democratic supervision, accountability, demarcation of responsibility or social and media surveillance will be ineffective. Especially in China, as the central government enjoys authority and initiative over promotion of local officials, if there are no effective quantitative indexes, there will be a lack of direction of efforts and officials cannot be held accountable; as a result, these officials will lose responsibility and motivation for economic development and cease to value innovation. The GDP-centered (plus maintenance of stability) performance evaluation in the past brought about high-speed economic growth along with many problems and contradictions, and we should not go from one extreme to another. That is to say, we cannot completely leave aside GDP growth goals at present. Instead, proper economic growth goals are needed more than ever.

External surveillance from the media and society also play a key role. Media is one of the four powers (with the others being political, judicial and administrative powers) to supervise the government and it should and can play a role of “supervision by public opinion, mouthpiece of the masses, mirror of the government and trailblazer of reform” proposed by former Premier Zhu Rongji in 1998, in order to promote executive efficiency and administrative efficacy of the government and greatly reduce corruption. Besides, local people have a better understanding and more information about public service quality of local governments while there is information asymmetry between local and central governments. Hence, opinion polls of local people should be included in the political performance assessment system to allow the public to participate in and improve the assessment mechanism as well as provide more accurate information. In this way, the top-down accountability and bottom-up supervision will effectively regulate inaction and arbitrage of the government and its officials.

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## 4 Further Discussion

The coming ten years will be a critical period for China's reform and development. In order to break the deadlock for reform for the next stage, we need to be persistent and determined in the general direction, strategy and guideline of reform. With the prospect of sustainable economic development in mind, China needs the transition from factor-driven to efficiency-driven and innovation-driven growth as soon as possible, of which the key is to encourage progressive thinking, to promote reform and opening-up, to unswervingly follow the path of economic liberalization, marketization and privatization, to let the market truly play a decisive role in allocation of resources and the private economy play a dominant role in the national economy. Only in this way can we clearly define reasonable governance boundaries between government and market as well as government and society, establish a sound inclusive system for sustainable development, achieve modernization of China's state governance system and governance capacity and maintain lasting stability.

Of course, the advancement of China's deepening reform in a comprehensive manner requires not only vision and mission, but also concrete implementation of comprehensive reforms in economic, political and social fields. In this book, we have also made specific analyses of reform and development issues in 14 fields such as the political system, rule of law, cultural system, opening-up, rural reform and urbanization, factor markets, financial system, state-owned enterprises reform and private economy, financial and taxation system, social security system, medical and healthcare system, ecological civilization system and education system. This helps us provide public policy suggestions for deepening reforms in relevant fields and for the establishment of state governance system.