

# **ECONOMIC REFORM AND DEVELOPMENT — THE — CHINESE WAY**

中国经济改革发展之路



**Li Yining**



外语教学与研究出版社

FOREIGN LANGUAGE TEACHING AND RESEARCH PUBLISHING

# **ECONOMIC REFORM AND DEVELOPMENT**

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Translated by Ling Yuan

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# Preface

The 16 essays featured in *Economic Reform and Development the Chinese Way* were chosen from amongst those I wrote and published during the period 1980-1998. They are reflections of my thoughts on certain important issues pertinent to the economic development of China in the intervening years.

For instance, the opening piece, “The role of education in economic growth,” was published in 1980, when the nation was setting about the task of confronting and resolving long-neglected issues shortly after the adoption of the policy of reform and opening up to the world. I was keenly aware of the fact that as a result of the decade-long “cultural revolution” that started in 1966, education had been seriously damaged and its development gravely held back because it was despised by leaders and the masses alike. Consequently, it was imperative to attach the utmost importance to developing education and cultivating talents, and it was against that background that the paper was written. In it I pointed out that if education continued to be scorned in such a manner, China would lose both its present and its future.

“Basic thoughts on economic restructuring” was written in 1986, a little more than seven years after the initiation of economic restructuring in this nation in 1979. By that time, a household contract system had been adopted in rural areas nationwide, which brought about a dramatic increase in farm produce output and an initial improvement in rural living standards. However, in urban areas, the development of state enterprises was hampered, as their management was encumbered by government intervention and their property rights were ill-defined. The promotion of urban economic restructuring thus became the next crucial task. In that paper, I suggested

that corporate reform be put before anything else, but that its main thrust should be directed at introducing the joint stock system and transforming state enterprises into firms that were liable for their own profits and losses, enjoyed autonomy in business activity, and were operated by a wide spectrum of investors. I believed that this suggestion, if adopted, would ensure success in economic restructuring and provide institutional guarantees for smooth economic growth in this nation in the years to come.

In “A tentative study of socialist ownership structure,” published in 1987, I introduced diverse forms of ownership that might work for the Chinese economy in the long term. I predicted that the nation’s ownership system would eventually include two economic forms: first, a small number of large corporate groups each funded by several investors; and second, legions of medium-sized and small private and cooperative firms, including self-employed industrial, commercial, and farming households under a contract system, the majority largely invested by individuals and cooperatives. This dual economic system would play a positive role in promoting economic growth and technological progress, in relieving the pressure on employment, and in raising resident income.

“Coordinating economy and environment in less developed regions” was published in 1991, the year I, as advisor for the State Council Commission of Environmental Protection, spent considerable time on environmental economics. During my field surveys, I was able to see more and more clearly the intimate relationship between the economic development of impoverished areas and environmental protection. I realized that if we went single-mindedly to help local communities defeat poverty without working to coordinate the economic and environmental concerns, we could end up getting half the result with twice the effort, thus failing to deliver those communities from poverty and lead them onto the road of prosperity. A year later, the Chinese government established the China Council for International Cooperation on Environment and Development, and I was appointed as a Chinese member on the council and director of a working panel of experts in environmental economics. That position enabled me to go on with my research and policy consultancy service in this field.

In 1993, overheated investment triggered high inflation, which riveted the attention of economists in this country and prompted them to search for solutions to the problem. I wrote “Growth and fluctuations in economic disequilibrium” to spell out my opinions on government regulation policy. Specifically, I focused my analysis on two “alert lines” under conditions of disequilibrium. Given the imbalanced development in the Chinese economy, I asserted, it was inevitable for either the unemployment rate or the inflation rate to run higher than zero, and therefore, it was impossible to set the alert line on a zero unemployment or inflation rate. At what level of unemployment or inflation the alert line should be set should be determined in light of the actual situation. Moreover, there should be two alert lines, designated respectively as the first alert line and the second alert line. Accordingly, the operational space for the entire economy should be divided into four segments along the zero unemployment axis or the zero inflation axis, and along the first and second alert lines.

In Segment One, the economy runs below zero unemployment or inflation, which is deemed abnormal. This gives rise to workforce shortfalls or deflation, which calls for macroeconomic regulation and control steps.

In Segment Two, the economy runs above the zero unemployment or inflation axis without breaking through the first alert line, which is deemed normal, and does not necessitate governmental microeconomic regulation and control.

In Segment Three, the economy runs above the first alert line without breaking through the second alert line, which is slightly abnormal and calls for moderate macroeconomic regulation and control.

In Segment Four, the economy runs above the second alert line, which is abnormal to a grave extent and calls for intensified macroeconomic regulation and control, and, when things come to a head, extraordinary control steps.

In 1997, when Southeast Asia was engulfed in a major economic crisis and the Chinese economy was affected to a certain degree, I wrote “Meshing fiscal policy with monetary policy.” Its gist was that whether in dealing with this crisis or in executing the national economic policy, we have to learn

how to coordinate financial policy and monetary policy. To tighten or loosen financial and monetary policies at the same time is something that can be done only under extraordinary circumstances. Under normal circumstances, a tight financial policy should complement a relaxed monetary policy, or vice versa. Only thus can good results be achieved in regulating national economic development.

“The dual foundations of efficiency” was published in 1998. It was written at a time when, with marketization making steady headway, the public had sufficiently understood the importance of efficiency but was yet to see the importance of the foundations on which efficiency rests. I pointed out in this paper that efficiency rests on two foundations, that is, the material and technological foundation, and the moral foundation. Equipment, factory buildings, raw materials, and workers’ technological attainment are elements in the material and technological foundation of efficiency, while its moral foundation consists of people’s faith, confidence and cultural and moral attainments. History has proved that the material and technological foundation can only engender conventional efficiency. The moral foundation, however, can generate super efficiency. This bears out the momentous value of people’s faith, confidence and edification in culture and morals. In developing its economy, the nation is faced with the urgent task of bolstering up the moral foundation of efficiency, so that the moral and cultural character of the population can play a still greater role in economic development.

Having given a glimpse at the essays selected in this book, I believe that readers who have read this book will gain some insight into my basic thoughts on Chinese economic development from the 1980s through the 1990s.

In publishing *Economic Reform and Development the Chinese Way*, I have benefited from the unstinting help of Professors Hao Ping, Ling Yuan, Norman Aprichard, Cai Hongbin, and Zhou Li’an. Without their unstinting assistance, it would have been impossible for me to put the book on readers’ desks in such a short span of time. My heartfelt gratitude is also due Director Yu Chunchi and Chief Editor Cai Jianfeng of Foreign Language Teaching and Research Publishing, who made this translation project possible in the

first place. Ultimately, I am immensely grateful to Wu Hao, managing editor of humanities and social sciences publishing, and translator-editors Zhong Zhilan, Ren Xiaomei, and Peng Lin, for doing a good job in producing this highly readable English edition of my selected economic essays.

**Li Yining**

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*January 30, 2010*



# Foreword

The success of China's reform and development in the last thirty-two years has attracted global attention. The major steps which have led to China's success exhibit many Chinese characteristics. Of these the most striking is the ownership reform in the state and other non-private sectors. The theoretical and policy preparations for ownership reform took more than ten years. From being heterodox in the mid-1980s they had become mainstream thinking by the mid-1990s.

Professor Li Yining was arguably the most eminent figure in this process. His most influential public speech on ownership reform entitled, "Basic thoughts on economic restructuring" (Essay No. 3 in this selection), was delivered on April 25, 1986 in Peking University. His famous remark, "Economic restructuring may break down if price reform fails. The success of economic restructuring, however, hinges not on price reform, but on ownership reform, which entails revamping the corporate system," soon appeared in the headlines of a number of leading reformist newspapers and later on became a new proverb in the discourse of Chinese reforms.

In the mid-1980s, "market socialism," which was initially promoted by Oscar Lange and Abba Lerner, was the guiding principle of economic reform in China and Eastern European socialist countries. This principle advocated that the introduction of autonomy to state-owned enterprises (SOEs) would induce SOEs to behave like profit-maximizing firms. Once SOEs became sufficiently autonomous, comprehensive price reforms (i.e.,

price liberalization) would lead to the final success of the economic reform.<sup>1</sup> In line with this mainstream paradigm, Chinese leaders also endorsed the “big bang” approach and implemented a “one-shot” comprehensive price reform in the late 1980s, which, unfortunately, led to more problems than it solved.

At the other end of the spectrum of the reform debates, criticisms of the theory of market socialism and its reform practices in Eastern Europe since 1968, led by Professor János Kornai, became increasingly influential in the 1980s. Kornai’s book *Economics of Shortage* became a bestseller in economics and Kornai himself an iconic figure among young intellectuals in China. His insightful analysis of state ownership and bureaucratic coordination led many young economists to believe that without ultimate private ownership, the expansion of enterprise autonomy and self-management under impersonalized state ownership would not be a medicine that would be effective in curing the soft budget constraint (SBC) syndrome. The SBC syndrome would continue to dull the price responsiveness of enterprises and thereby constrain the effects of price signals. Kornai himself later also concluded that unless state property was sold to private owners at a real market price, an attempt to reduce the percentage of state ownership gradually, i.e., to 95, 90, 85 percent and so on would not be able to make a difference.<sup>2</sup>

In sharp contrast to the above strands of thought, Professor Li had a keen observation of the *de facto* diverse property rights structure existing in SOEs in China. He argued that it was feasible and desirable to adopt the shareholding system in SOEs by quantifying interests among different public

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1 For an excellent critical review on market socialism in general and its manifestation in the 1980s in particular, see Kornai, János (1992), *The Socialist System*, Princeton: Princeton University Press. For a leading essay on market socialism for China, see Sun, Yefang (1982), “Some theoretical issues in socialist economies,” originally published in Chinese in the period 1958-1961, in Fung, K.K (ed.), *Social Needs versus Economic Efficiency in China*, Armonk, N.Y.: M.E. Sharp. For an influential essay which promotes comprehensive price reform in China, see Wu, Jinglian and Reynolds, Bruce L. (1987), “Choosing a strategy for China’s economic reform,” *American Economic Review*, Vol. 78, No. 2, pp. 461-466.

2 See Kornai, János (1990), *The Road to a Free Economy*, New York and London: W.W. Norton & Company.

owners and then converting such quantified interests into shareholdings. With such a shareholding system in place, an individual public agency would have a measurable stake in the fortunes of a firm from which the agency would draw cash flow and control rights. As a result public agencies could more easily consolidate their material interests and assemble more consistent business strategies when facing market competition. They would find it in their best material interest to increase the value of the firm rather than to extend bureaucratic control over it. Furthermore, mixed ownership for a company as a result of joint investment by public, collective, and private partners and diverse forms of ownership in the economy would stimulate competition and induce further property right reform (also see Essay No. 4 in this selection, first published in 1987).<sup>3</sup>

In the context of China in the mid-1980s, when the official ideology still viewed socialist state ownership as 100 percent ownership by the state on behalf of the whole people, it was analytically valuable, practically significant, and politically brave and skillful to highlight the *de facto* plural property rights structure of existing state ownership and then to link this structure to the feasibility and desirability of ownership reform.

Within academic circles in the West, Granick (1990) appears to have been the first person to analyze this plural structure.<sup>4</sup> Highlighting that Chinese SOEs were in fact agents with multiple principals exercising control over them, he asserted that these multiple principals acquired property rights through past investment in SOEs or traditional associations with individual SOEs. He cited a 1966 slogan “whoever builds and manages the enterprise has the use of its output.” This slogan was regarded as epitomizing property rights relationships of the 1970s, i.e., instead of control rights being

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3 For more detailed and systematic discussions on multiple property rights and ownership reform by Professor Li, see Li, Yining (1986), *Political Economy of Socialism*, Beijing: Commercial Press; Li, Yining (1987), *An Exploratory Study of Economic System Reform*, Beijing: People's Daily Press; and Li, Yining (1989), *Thoughts on China's Economic Reform*, Beijing: Zhongguo Zhanwang Press. All these three books are in Chinese.

4 Granick, David (1990), *Chinese State Enterprises: A Regional Property Rights Analysis*, Chicago: University of Chicago Press.

derived from ownership, *de facto* control rights now define ownership. In other words, this practical property rights arrangement is opposed to the usual textbook teaching in which the right to management is an attribute of ownership.

Rooted in the Chinese reality, the analytical work of Professor Li reveals that the conventional wisdom on state ownership in both the West and East is descriptively narrow. The claim that private investors should own the firm, despite its importance, is not the unique logical prerequisite of free markets and free enterprise. Diverse ownership and governance forms can emerge and evolve that are compatible with the evolutionary development of free market and free enterprise. The Chinese like to create a nickname for someone famous for a particular legacy and, not surprisingly, Professor Li is now known throughout China, as “Li Shareholding.”

Another area to which Professor Li has made an important contribution is comparative economic history and the history of economic thought (cf., Essay No. 11 in this selection, published in 1993).<sup>5</sup> Integrating such comparative studies with his deep understanding of economic practices in China, he proposed an innovative augment on disequilibrium theory. As presented in Essays No. 5 (published in 1988) and No. 12 (published in 1993) of this selection,<sup>6</sup> he distinguishes two types of disequilibrium based on whether the majority of firms in the economy are viable profit-makers or not. The first type corresponds to the one dealt with in the existing disequilibrium theory, which features excessive demand or supply due to market friction, stickiness of prices and wages, and demand or supply constraints, rather than non-viability of firms. The second type is characterized not only by an underdeveloped market but also enterprises under various forms of bureaucratic control. He argues that China’s economy has belonged to the

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<sup>5</sup> Also see, for example, Li, Yining (2003), *The Rise of Capitalism: A Study of Comparative Economic History*, Beijing: Commercial Press; Li, Yining (2006), *The Economic History of Rome-Byzantine Empire*, Beijing: Commercial Press. Both books are in Chinese.

<sup>6</sup> More detailed and systematic analysis on this topic is presented in Li, Yining (1990), *Chinese Economy in Disequilibrium*, Beijing: Beijing Daily Press. This book is in Chinese.

second category throughout its transition process. To make the transition from the second type of disequilibrium to the first, the top priority is the reform of enterprise system with the aim of producing viable and profit-oriented enterprises.<sup>7</sup> This line of thinking provides a further support to his famous remark – “ownership restructuring holds key to the reform.”

In addition to constructing this second analytical foundation for his ownership reform theory, Professor Li’s work on the Chinese economy in disequilibrium also emphasizes the fundamental importance of achieving and maintaining healthy economic growth and social development in China under the conditions of the second type of disequilibrium. The majority of his essays in this selection discuss various coordination issues across economic reform, growth and development, and the urgency of finding solutions to immediate practical policy dilemmas. The central normative guideline has been that the reform and transition are means to serve economic growth and social development and, furthermore, that economic growth and social development are means to serve the well-being and happiness of ordinary citizens in society.

In dealing with the immediate policy dilemma, Professor Li has incorporated the methodology of “dialectical thought and synthetic analysis” of traditional Chinese medicine, which emphasizes holistic connections among many facets of human anatomy and physiology and examines the effect of the social and natural environment on the interrelations and conditioning of *yin* and *yang*. He pays particular attention to both the

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<sup>7</sup> An important parallel research on the viability issue of SOEs in China (and other transitional economies) has been conducted by Professor Justin Yifu Lin. Lin employs the analytical perspective of comparative advantage and argues that the firms in heavy industries prioritized by the government in transitional centrally planned economies are not viable in open, competitive markets because their activities are inconsistent with the economy’s comparative advantage. This viability problem is another root of the soft budget constraint (SBC) syndrome. If the viability problem is not solved, the SBC syndrome will not be eliminated even though the socialist government is overthrown and all firms are privatized. See, Lin, Justin Y. (2003), “Development strategy, viability and economic convergence,” *Economic Development and Cultural Change*, Vol. 53, pp. 277-308; Lin, Justin Y. (2005), “Viability, economic transition and reflection on neoclassical economics,” *Kyklos*, Vol. 58, No. 2, pp. 239-264.

“treatment effect” and “side effect” of each policy pill, as well as its short-run and long-run effects. For instance, the first essay of this selection was published in June 1980 when the high urban unemployment rate was at the top of policy agenda. With a thorough and comprehensive analysis of the historical and structural roots of the high unemployment rate, Professor Li suggested that in the short and medium run, the solution would be to actively develop labor-intensive manufacturing industries and labor-intensive export processing to take advantage of China’s abundant low-skilled labor force. However, in the long run, China has to develop human capital intensive manufacturing and services industries and actively promote human capital intensive exports so as to convert the persistent population pressure into an emerging comparative advantage. Therefore, it was strategically important to significantly increase investment in education in the 1980s so that China would no longer suffer high unemployment rates in the next two to three decades and become well prepared for the inevitable era of human capital-intensive production and exports. Clearly, this vision is still valid today.

The publication of this *Economic Reform and Development the Chinese Way* enriches the literature in English that examines the past, present and future prospects of China’s reforms, transition, and development. Although all the essays in this selection are well-known in China, they provide carefully examined alternative perspectives which scholars and students in the West may not be familiar with. I am honored to write the foreword for this excellent selection and commend it enthusiastically to scholars, policy makers, business professionals, as well as to more general readers, who are interested in the dynamics of China’s transition and the growing importance of China in the world.

**Sun Laixiang**

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*August 9, 2010*

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# **1980**

**The role of education in economic growth**



In my speech “Technology education and capitalist industrialization: a study of the rise of technological power in Western Europe and America,”<sup>1</sup> I dwelled on the relationship between education and economic growth in light of economic history. What I was driving at was that education is a major recourse for nations to groom technological personnel, and that only by putting a premium on education and the cultivation of talents can less developed nations boost their economic growth rates and catch up with and surpass the developed countries. As I put it in that speech, the role of education in economic growth has five aspects:

“First, education provides society with a supply of researchers and designers who can venture into the unknown, innovating in science, renovating and transforming productive technology. Without such contingents, the best a nation can do is to tag along after other nations, but in that way you cannot score major breakthroughs in science and technology.

“Second, education provides society with engineers and technicians who can master and apply advanced means of production. Without such technocrats, even if a nation has acquired sophisticated tools of production, it cannot put them to best use.

“Third, education brings forth production and technology managers well adapted to society’s level of industrialization. Without teams of such managers, the production process can be prone to colossal waste in human, material and financial resources, making it impossible to benefit from the superiority of advanced productive technology.

“Fourth, education enhances society’s scientific and cultural attainment, and sets the stage for promoting new products and disseminating and upgrading knowledge in science and technology. At the same time, education also lays the groundwork for the future growth of a nation’s technological prowess, and guarantees the supply of a constant stream of high-caliber researchers, engineers and managers, and skilled workers.

“Fifth, education enables society to preserve and disseminate its

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<sup>1</sup> This speech was delivered at Peking University’s 1978 “May Fourth” Science Forum, and carried in *Social Sciences Front*, issue No. 4, 1978.