

Chief Editor: *Chi Fulin*

CHINA'S ECONOMIC REFORM AT THE TURN OF THE CENTURY

China Institute for
Reform and Development



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China's Economic Reform at the Turn of the Century

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PREFACE

To suit the needs of the time, the China Institute for Reform and Development (CIRD) was set up during the process that China was advancing to a market economy. The changing era calls for innovative ideas, and the practice of reform requires the theory of reform. The commitment of China to move to a market economy provides immense chances and also challenges to the CIRD, as well as new assignments of important and tough historical tasks.

Ever since its establishment on November 1, 1991, the CIRD has been developing vigorously, and is now widely known at home and abroad. The CIRD designed its organizational structure according to the market and in the way of reform. The institute has applied a new way for running the institute with the support from the society, known as the idea of “small organization and big network”, —a breakthrough for the development of academic institutions. In its academic researches, the CIRD has committed itself to promoting the transition of China to a market economy. In the past years, it has sponsored a series of research activities which focus on the important and hot issues concerning the economic transition in China. Altogether more than 70 academic conferences (includes more than 40 international symposia) were held, 30-some policy proposals were concluded, more than 50 books were printed and over 500 articles were published on various journals and newspapers.

Other noticeable activities the CIRD has engaged with were its emphasis on practical research. As early as in 1991, it raised the suggestion of marketizing state-owned assets and turning state-owned assets into state capital; in 1994 its theory of “labor property right” had an important impact on promoting the reform of state-owned enterprises (SOE); in 1994, the suggestion of controlling inflation during rapid

economy growth was accepted by the central government in formulating its economic policies; in 1995, the CIRD's proposal on speeding up the reform of commercial banking system while focusing on solving bad debts also aroused great attention from the central government which held a special meeting to evaluate the proposal; on July 10th of 1998, the proposal submitted by the CIRD on long-term and secure rural land use right was adopted in the final document of the 3rd Plenary Session of the CPC Central Committee, in which the proposal of "giving farmers long-term and secure land use rights" was directly quoted.

The objective of the CIRD is to serve China's policy-making procedure in economic reform. This book discusses many important subjects such as the macroeconomic policy of China under the challenge of globalization, SOE reform in China, rural economic reform, poverty reduction, government's role and regional economic development. Based on China's practice of opening to the outside world and reform, the book, soliciting suggestions and opinions from domestic and foreign experts on relevant issues, aims at serving policy-making for the economy.

It is a collective work of the research results by the CIRD's staff. In the past years, the institute's researchers have followed closely the progress of China's economic reform and provided a series of policy proposals for relevant departments of the central government as reference, making active contributions to the economic reform in China.

China is now advancing towards a market economy. The CIRD will devote itself to this undertaking with full faith, enthusiasm and efforts.

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Introduction

**The Role of Economic Reform in
the Growth of the Economy
at the Turn of the Century**

By Chi Fulin

It is a long-standing policy for China's transitional period to push forward economic growth through reform and opening to the outside world. At present, China's economic and social development is confronted with new challenges, for the domestic and international environments for reform and opening-up have become ever more complicated. To maintain China's sustained economic growth in such a situation, an important solution still lies in reform and opening to the outside world. The practice in the past two decades since the 3rd Plenary Session of the 11th CPC Central Committee has testified that reform and opening to the outside world are power engines behind China's economic development. This is the most essential experience of the past two decades.

How to maintain sustained and rapid economic development through further reform and opening to the outside world in a new situation today? The following two judgements are very critical.

Firstly, how to judge the role of reform in stimulating economic growth in a situation of persisting deflation? Influenced by the Asian Financial Crisis, China's market has suffered low demand. Unlike developed countries, China still has a great market potential, owing to its immature market mechanism, low level of urbanization and industrialization and unbalanced regional development between the urban and rural areas and between the eastern and western parts. There are much rooms to maneuver to stimulate market demands by establishing a larger unified market

through further reform. Facing persisting deflation, it is important to increase government spending, and this is a very important measure to *vitalize the market and increase growth*. However, it is very essential to use the government spending to attract the investment by enterprises and the society. In reality, to attract investments from other sources, it is imperative to accelerate the reform. While increasing the government's spending, we must speed up the reform of the investment and financial system of China and create a competitive environment for attracting investments in infrastructure development from all possible sources of the society. To summarize, the solution to deflation is reform, and reform, which has become increasingly urgent, is still the driving force for pushing forward economic growth.

Secondly, how to judge the role of speeding up the reform of state-owned enterprises in the country's economic growth? State enterprises possess about 70% of all social resources, yet only contribute to about 30% of economic growth. Years of poor performance and even heavy losses of state enterprises have become important factors retarding the economic growth. From a comprehensive perspective, the achievement of the reform of state enterprises has become critical for economic growth and social stability.

The above two judgements show that economic reform is confronted with new challenges in a new situation, and reform is still the fundamental solution to problems blocking economic growth. The reform in the next stage will directly influence the volume and quality of economic growth. In spite of current complicated situation that have increases the difficulties, reform should still be accelerated and carried out in a resolute way. Only through continued reform and a sustained and rapid economic growth can it be possible to solve all kinds of complicated social problems.

I. The Reform of Income Distribution System and Economic Growth

A reasonable distribution system is an important condition for economic growth. Firstly of all, as the most important factor of produc-

tion, workers can only bring their ability into full swing and transfer such ability into material returns under a reasonable distribution system. Secondly, a reasonable distribution system can directly stimulate consumption and increase market demands, thus facilitating economic growth. The 15th Party Congress put forward the idea of allowing factors of production to participate in distribution. The way in which factors of production participate in distribution, especially the most important factor of production—human labor—is directly related to economic growth. In reality, two types of enterprises deserve our attention: joint ventures and enterprises adopting the employees stock ownership program (ESOPs). In general, the economic performance of joint ventures is better than that of state enterprises. However, there are a large number of managers and technicians in joint ventures who had previously worked for state enterprises or government departments. Similarly, most of the enterprises with ESOPs have better economic performance, especially those in which the entrepreneurs and managers hold a large portion of the stocks. An important explanation to this phenomenon is the effect of the distribution system. In order to set free the factor of labor force from the original system and bring into full play the initiative of the laborers, it is imperative to accelerate the reform of the income distribution system.

In the past twenty years, there has been a great breakthrough in the reform of the ownership system in China, but the progress of the reform of income distribution system was very slow without obvious change. This has affected the initiatives of the workers and managers, and is also one of the main factors of low-efficiency and corruption. The reform of income distribution system is an important condition for forming reasonable property relationships. The reason why we develop a socialist market economy is to the benefit of the majority of workers. The reform of distribution system, therefore, has become the most substantial part of further economic reform in China.

There is still an argument about how labor should participate in the distribution as the most important production factor. The workers' greatest contribution to the economic growth is to increase their labor input, which is the main form of their investment. Therefore, to distrib-

ute a portion of the residual profits to workers is an important condition for workers to invest more of their labor capital.

Several years ago, I proposed a term of "labor property right". What I want to emphasize is that workers should not only be entitled to receiving their wages and salaries, but also enjoy a certain degree of additional profits derived from their labor property right in accordance with their work posts, contributions and employed period. The purpose to put forward this idea of "labor property right" is to explore a new way for income distribution under a socialist market economic system. In 1952, the state-owned assets in China valued merely 20 billion yuan Renminbi, yet the total value increased to 3,500 billion yuan Renminbi in 1996, an increase of over 200 times in 40 years. The huge accumulation of state assets contains the contribution from the workers. If we recognize such a fact, and adopt various ways combining stock purchase with free distribution of stocks among the workers to realize labor property right during the reform of SOEs, the workers will have great enthusiasm in their work and will put in more labor. Thus a common interest group, which integrates the rights of the employees, managers and the enterprise, will be formed. The experiment in some enterprises shows that recognizing labor property right and practicing ESOPs are important factors for improving the economic performance of enterprises. Major reforms in the distribution system, especially in the economic transition period, will rationalize the property right relationships, give more freedom to enterprises and increase productivity.

The reform of the income distribution system is an important way to help state-owned enterprises, especially those small and medium-sized ones, out of the current difficulties. So we suggest adopting various forms in the transitional period to apply the ESOPs on the basis of labor property right. For instance, small and medium-sized enterprises can adopt the full employee ownership system through ESOPs; for enterprises with good profits, the system of supplementary pension annuity can be a transitional form for ESOPs. In addition, rational divisions of shares among different levels of management and employees are decisive for establishing effective corporate governance and consequently enhancing the profits by wide margins.

II. The Reform of Infrastructure Sector and Economic Growth

Increasing investments in infrastructure development has become an important way to stimulate economic growth, particularly under the current macroeconomic situation, for infrastructure development plays a significant role in stimulating market demands as well as in the strategic restructure of state-owned assets. To make the infrastructure sector more efficient and sustainable, the expansion of investments should go hand in hand with reforms.

In the current economic situation, three points should be clarified.

(1) Who should be the major investor for infrastructure development? The Chinese government recently announced that the investment for China's infrastructure development in the next few years should reach US\$ 780 billion, an amount obviously unaffordable for the government. Therefore, it is of critical importance for the government to attract investments from all sources by its own initial investment in the infrastructure sector. In order to do so, reforms have to be conducted in the infrastructure sector to create proper conditions and environment for investments from various sources.

(2) The effectiveness of investments in the infrastructure sector should be emphasized while increasing capital inputs. Statistics show that a mixed investment structure has higher effectiveness than pure state investments.

(3) Government investment often runs the risk of low effectiveness, as a result of redundant construction projects or blind investment, etc. Therefore, the government's ability in making investments is quite limited. We should pay special attention to such problems, and try to attract more investments from various sources.

Then how to stimulate economic growth through the reform of the infrastructure sector? The following suggestions concerning policies should be put into consideration.

Firstly, we should allow the society, enterprises and individuals to invest in a certain proportion in some key industries in the infrastructure sector or the state public departments, such as telecommunications,

civil aviation, electricity, road, railroad and water conservancy works, and should also allow outside investment.

Secondly, we should speed up the reform of setting up companies in the infrastructure sector, and attract diversified investment.

Thirdly, we should create a favorable environment for social and foreign capital to enter the infrastructure sector. For instance, how to convert a part of the huge individual savings deposits into investment funds, or encourage large companies to invest in projects providing compensated services, or create an effective mechanism to attract more capital input? Increasing investment in infrastructure development has become an important way for stimulating China's economic growth across the century. In addition, the reform of the infrastructure sector is instrumental for the overall strategic restructuring of the national economy.

III. The Reform of Small and Medium-sized Enterprises and Economic Growth

Among China's enterprises, 99% of them are small and medium-sized. Even in state-owned enterprises, small and medium-sized enterprises take up over 85% of the total. As reform deepens, the number of small and medium-sized enterprises is still growing.

The practice in China clearly shows that robust growth of small and medium-sized enterprises is an important basis for the sustained and stable economic growth. While developing large enterprise groups, we should take various measures to actively encourage the development of small and medium-sized enterprises. At present, China's investment and financing systems do not match the core force of economic growth well. In recent years, the most dynamic forces pushing forward economic growth are the non-state sector as well as small and medium-sized enterprises. Nevertheless, state-owned banks and the financial market are opened to the SOEs, but are discriminative against the non-state sector and small and medium-sized enterprises in providing financial services, making their channel of financing increasingly narrower. Since banks provide preferential treatment for large SOEs, key industri-

es as well as key regions in loan provision on the basis of evaluating loan costs and risks, it is rather difficult for small and medium-sized enterprises to get loans. Moreover, the prospect for the non-state-owned enterprises and small and medium-sized enterprises to get financing from the capital market by issuing stocks and bonds is bleak. Therefore, financing difficulty is the crucial factor strangling the development of small and medium-sized enterprises.

How to develop small and medium-sized enterprises is a task for both economic reform and economic growth in China. To fulfill the task, a "package of policies" should be implemented to accelerate the reform of small and medium-sized enterprises and support their development.

Firstly, the financial service for small and medium-sized enterprises should be improved. The government may consider set up a special fund for providing loans to small and medium-sized enterprises. On the basis of rectifying local exchange markets, the government may also broaden financing channels for non-state-owned enterprises and small and medium-sized enterprises. A secondary market for equity exchange might be established in Shanghai and Shenzhen to create conditions for the circulation of the equity of small and medium-sized enterprises.

Secondly, small and medium-sized enterprises should be encouraged to make investments in some of the infrastructure projects. In stimulating demands and economic growth, it is even more important to mobilize investments from enterprises than increasing the government's spending.

Thirdly, various preferential policies should be adopted to support the development of small and medium-sized enterprises. For instance, we should establish a development fund to support the technological upgrading in small and medium-sized enterprises, support the investment of small and medium-sized enterprises by means of investment tax credit, reduce various unnecessary tax of fee, and strengthen law enforcement to create a healthy environment for the development of small and medium-sized enterprises.

Fourthly, various reform measures aiming at invigorating small and medium-sized enterprises should be allowed and encouraged to speed up the pace of reform.

Clarification of property rights is an important condition for maintaining the dynamics of small and medium-sized enterprises. Therefore, the reform of property right system should be actively supported and encouraged in state-owned small and medium-sized enterprises. Small and medium-sized state-owned enterprises with good economic achievements can be transferred into companies or joint stock companies while those with poor economic achievements or even losses can be merged, auctioned or sold. The most important thing at present is to create all kinds of incentives for investments from the society, enterprises and employees. The situation of small and medium-sized enterprises should be improved in no delay, and reform is the only way out.

IV. The Reform of Housing System and Economic Growth

Owing to historical reasons, the reform of housing system in China's urban areas, to some extent, has the characteristics of social redistribution. Given such a historical factor, it is only logical to facilitate the reform of housing system with various preferential policies. On the other hand, the following two points deserve special attention. Firstly, the rate of savings in China has long been high while the state-owned commercial banks have a low efficiency in their operations. To worsen the situation, some loans have been issued to loss-making state-owned enterprises, making it difficult to generate good profits from the expanding savings. Secondly, it is important to stimulate the purchase of houses in the situation of deflation. Good policy measures can not only stimulate house purchasing itself, but related consumption such as interior decoration as well.

On the basis of the above-mentioned, we offer the following two suggestions for the reform of housing system in China.

Firstly, the government should reduce or exempt land fees and other taxes or fees related to housing. It is estimated that all types of taxes and fees take up 60% of the cost for house construction. A reduction or exemption of the 60% of the cost would significantly bring down the housing market prices and therefore stimulate the

purchase of houses.

Secondly, low-interest or interest-free loans should be provided to stimulate the housing consumption. The housing system reform is an important way to stimulate China's flat consumption market. To make it feasible, the state may consider subsidizing loan-providing banks on reduced interest with profits brought forth by the overall economic growth. Such an alternative is better than investing money in projects with poor economic prospects.

Consumption demand is the ultimate demand, and the essential way to stimulate demand is to stimulate consumption demand. It would be woefully wrong to produce for the sake of production and invest for the sake of investment. China's current policies in housing system reform have failed to effectively stimulate the consumption demand, for on the one hand, people are in need of houses and on the other hand, house sales tends to be sluggish. The reasonable housing vacancy rate should be within 3-5% while the vacancy rate in China is now as high as 16%. Therefore, to reform the housing system and thus stimulate consumption demand, the government should issue more preferential policies and play a more positive role in the overall coordination of housing system reform work.

V. The Reform of Rural Land System and Economic Growth

The distribution relationship among the state, the collective and farmers is essentially reflected in the land system, where the breakthrough in China's rural reform was made. With independent land use rights, farmers would have been willing to invest in their land, thus bringing about upheavals in China's rural areas in the past two decades. It is pointed out in the Decisions of the 3rd Plenary Session of the 15th CPC Central Committee that "land is the most essential factor of agricultural production and the guarantee of farmers' basic livelihood. With a stable land contractual relationship, farmers will increase their investment in land and enhance land productivity, thus maintaining the rural stability." Through years of reform, the broad masses of farmers all wish to have a long-term and stable land use rights, so that they can