WILL CHINA'S ECONOMY CONTINUE TO GROW?

A HISTORICAL ASSESSMENT OF CHINA'S ECONOMIC REFORM AND A PERSPECTIVE ON ITS FUTURE

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My interest in China's economy, its growth and development, and its position in the global economy was fostered during my internship at the Embassy of the Netherlands in Singapore and Brunei. Many thanks go out to my former colleagues, and in particular to my supervisor, Mr. Ernesto Braam, for encouraging me to challenge and immerse myself in unfamiliar fields.

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This thesis examines China's economic reform since early 1979 and the sustainability of the economic growth it has produced. 40 years ago, the Communist Party of China (CPC) initiated economic reforms. The reform took place in two phases. The objective of the first was to establish a dual-track economy, in which the institutions of the planned economy would come to coexist with forces and principles common to a market economy. The second phase aimed to implement a socialist market economy: the government would maintain its control over the macroeconomic environment, certain sectors and SOEs, but the market would be the coordinating mechanism. This thesis argues that during 40 years of reform, the economy has neither been generally planned and controlled, nor generally liberalised and open. Additionally, while this mixed economy has fuelled China's spectacular economic growth, it has insufficiently changed the business environment and the role of the government in the economy, because of which concerns are now being raised over the durability and sustainability of China's growth. This thesis finds that advancing economic growth depends on China's ability to further reform the business environment and the role of the government but might prove difficult, as such economic policy changes require social and political reform.

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ABBREVIATIONS AND ACRONYMS

CPC	Communist Party of China
EPZ	Export-Processing Zone
FDI	Foreign Direct Investment
FTC	Foreign Trade Company
GLF	Great Leap Forward
HDI	Human Development Index
IPR	Intellectual Property Rights
LLC	Limited Liability Company
NPL	Non-performing Loan
PBC	People's Bank of China
PRC	People's Republic of China
REC	Reemployment Centre
RMB	Renminbi
SEZ	Special Economic Zone
SME	Small and Medium-sized Enterprise
SOE	State-owned Enterprise
SPC	State Planning Commission
TVE	Township and Village Enterprise
VAT	Value-added Tax
WTO	World Trade Organisation

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INTRODUCTION

December 2018 marked the 40th anniversary of the Communist Party of China's (CPC) decision to start economic reforms. This process was set in motion during the 3rd Plenary Session of the 11th Central Committee of the CPC[1], held in December 1978. Over these 40 years, the People's Republic of China (PRC) has managed to grow from underdeveloped country to a global economic powerhouse and to become the second largest economy in the world in 2017[2]. Now, two aspects related to China's economy continue to be questioned, in academics and in business: does China's economy generally adhere to the principles of a planned or a market economy?; and, more broadly, will China's economic growth continue, or will it end?

In general, this thesis is framed by the question of whether China will be able to continue its economic growth. Yet, the bulk of its analysis attempts to answer to what extent China's economy has been reformed: to what extent has it been liberalised, and to what extent has it been kept under control, since the beginning of 1979? As such, it seeks to uncover how 40 years of economic reform and market transformation have propelled China to a global economic power. It will be illustrated that the Chinese economy has been restructured in such a way to encapsulate elements of socialist planning into a capitalist market economy, rendering the economy neither generally planned and controlled, nor generally liberalised and open. Based on this analysis, this study discusses

[1] Hereafter referred to as '3rd Plenary Session'
[2] Ranked by GDP. If ranked by GDP at PPP, China is the largest economy in the world. See the World Bank GDP ranking (https://databank.worldbank.org/data/download/GDP.pdf) and the GDP PPP ranking (https://databank.worldbank.org/data/download/GDP_PPP.pdf).

whether further growth will be possible. It will argue that the challenges to continued economic growth China is currently facing are rooted in aspects that been insufficiently addressed by or changed during the reform: the hold of the Chinese government over its SOEs, its control over the financial system, and the fairness and transparency of the business environment. Advancing economic growth, then, will depend on China's ability to further reform these, as they will have ripple effects on other challenges and opportunities.

This study will unfold in four sections. The first will address China's planned economy, to provide the background information upon which to explain the reform procedure. Subsequently, the second and third chapters will analyse the reform strategy in detail. The second chapter will address the first phase of economic reform. The focus in this phase was on establishing a dual-track economy: by gradually reducing the dominance of the planned economy, especially in agriculture and urban industry, while allowing for a controlled opening up to market forces, a planned and a market economy would come to coexist. The third chapter examines the second phase of reform. This period centres on accelerating marketisation by looking at the bigger picture: key in this phase was reforming the macroeconomic environment and establishing an institutional and regulatory framework supportive of a market economy. Next, the fourth chapter will elaborate on one consequence and two challenges China is now facing as a result of its economic growth, and identify which opportunities lie ahead to mitigate these and potentially advance further growth. Finally, this research will be concluded by bringing the historic assessment and contemporary perspective together in order to sum up the

progress that China has made during 40 years of economic reform and identify where more effort should be directed to.

As such, the objectives of this research are twofold. First and foremost, by historically assessing the reform procedure, this study aims to clarify misconceptions or uncertainty about China's economic system, particularly by emphasising the aspects that the reform has not been able to fully address by or convert to the standards of a market economy. Second, by evaluating the sustainability of China's economic growth in the 21st century and using it to frame the historical assessment of the reform, the research aims to provide an understanding of the successes and shortcomings of the reform process. The relevancy of this study lies in the combination of the first and second objective. Given the size and power of China's economy, the durability of its economic growth is relevant to and followed closely by scholars and experts, governments and political institutions, but also internationally operating companies. As such, in providing a historical assessment and a contemporary perspective of China's economic growth, this study positions itself at the intersection of academia and business, and by doing so, it adds an understanding of China's economy valuable to both.

I. THE PLANNED ECONOMY

In order to understand the full extent and grasp of 40 years of economic reform, any analysis of China's economic transformation will have to start with examining its pre-reform economy. From 1949 onward, China adhered to a planned economy, or a socialist economic system, for roughly 30 years. Every aspect of economic life, from production to profits and prices, from labour to wages and consumption, was governed by the state and subjected to plans and targets. However, during certain periods, some market mechanisms could coexist next to or within the plan, as China's economy was too large and diverse for the plan to have an effective authoritative hold over.

China's pre-reform economy clearly reflected the three principles commonly ascribed to a planned economy or a socialist economic system. First, economic life is controlled by a single party. Second, the economic institutions are based upon collective, or state, ownership of the means of production. Indeed, with the establishment of the PRC in 1949, the CPC took over the government. As the CPC's implementation of the Marxist-Leninist ideology brought with it a scepticism of capitalism (Chavance 2000, 5; Perkins 2015, 42), the party initiated a state takeover of the economic institutions. The production, consumption and distribution systems of industry and commerce – which were, up to that point, governed by market forces – were removed. The realities of China's endowments – abundance of labour, scarcity of capital – were ignored; industry, and especially heavy industry, was favoured over agriculture, and production over consumption (Chavance 2000, 5). Third, compulsory central planning is the main

mechanism driving the economy. The CPC implemented a centrally planned system and set up the State Planning Commission (SPC), which allocated resources directly through its own commands and decided which enterprises would receive what type and quantity of inputs for production (Lavigne 1995, 3; Naughton 2007, 55; Perkins 2015, 41). This strategy, referred to as the "Big Industrialisation", lasted for approximately 30 years. The CPC used the Soviet Union as its model to construct its interpretation of a socialist economy upon and turned to it as its primary trader and source of technology, training and advice[3] (Naughton 2007, 55, 59-60, 66; Perkins 2015, 41; Zimbalist and Sherman 1984, 339). Besides these contacts, China's economy was closed off from the rest of the world. These economic characteristics, and China's interpretation of them, are juxtaposed against those generally associated with a market economy in table 1.1 on the next page.

As the plan governed economic policies and forces instead of the market, the SPC was responsible for all planning-related mechanisms. The Commission governed many ministries, responsible for directing the production of products by state-owned enterprises (SOEs). In principle, the entire economy was governed by separate ministries, and hence, by plans. These ministries covered sectors ranging from agriculture, fisheries and forestry to natural resources, nuclear energy, textiles, machinery, consumer products, military goods, transportation and infrastructure, telecommunication, con-

[3] During the 1960s, China and the Soviet Union broke their ties and China started to change its economic institutions to fit Maoist ideology, thereby resulting in a Chinese vision of socialism distinct from the Soviet model. This vision was mostly based upon Mao Zedong's own wishes and ideas and carried out by himself (Naughton 2007, 60, 62, 69; Perkins 2015, 46).

Table 1.1
Contrasting Characteristics of a Planned and a Market Economy, and China's Interpretation

	Planned Economy	Market Economy	China's Economy (1949-1979)
Ownership of productive factors	State	Private	State: CPC
Coordination	Plan	Market	Plan: set up, directed and enforced by SPC
Role of government	Authoritative, controls economy by setting goals and targets and intervenes when deemed necessary	Limited, protects and enforces key institutions and only intervenes to correct market failures	Authoritative, controlling and intervening, all in accordance with the plan
Individual, entrepreneurial freedom	Generally low	Generally high	Low: SOE production and operations in hands of SPC
Openness to trade	Generally low	Generally high	Low: essentially only open to Soviet Union

struction, and finance (Chow 2012, 27). The SPC set targets for industry inputs and output in five-year plans, which were divided into five annual plans. In theory, the SPC used 'material balances planning' as the coordinating mechanism to replace market forces (Naughton 2007, 61; Perkins 2015, 43). As such, the SPC engaged in input-output analysis in which the interdependent needs of inputs and outputs of the entire economy were matched. It collected data related to the output targets from every enterprise and coordinated these with each other, to make sure that every enterprise would be allocated the right amount of inputs to achieve their production targets. These had to be matched closely in order to be able to produce efficiently, as outputs from one sector, such as steel, were used as inputs in another, such as machinery, or were made available for consumption. However, according to Naughton (2007, 61) and Perkins (2015, 43), in

practice this proved to be too difficult and slow for China's big and diverse economy. As a result, the planners used approximations to establish their targets and prioritised some sectors (military goods) over others (consumer goods), to ensure that their core interests were protected.

Additionally, targets were not only set for resource inputs and product output, but also for SOE operations. The number of employees, rate of equipment utilisation, average wages, labour productivity and profits were all subjected to targets (Perkins 2015, 44). The state controlled SOE finances by setting prices and allocating funds and investment – originating from the profits that the enterprises made, which had to be turned over to the government – according to the plan. Adjustments to their labour force and production procedures were therefore difficult to realise, and little to no funds went into research and innovation (Naughton 2007, 61; Perkins 2015, 44-45). As such, by limiting their decision-making autonomy, it was ensured that SOEs cooperated with the state plans and protected the state's core interests.

The enormous amounts of data required for the plans to be realised illustrate the difficulty China encountered in implementing the planned economy. Additionally, the SPC came to realise that not every sector could be fully planned. The agricultural sector illustrates this well. From 1949 onwards, land reform and redistribution were implemented rapidly, and farmers were expected to join collectives (Naughton 2007, 64). However, efforts to plan agricultural output for these collectives proved to be difficult – there simply were too many farm production units, each subject to different climatic and topographic conditions – because of which some form of a market economy could exist

next to the plan. Government-set quotas remained for grain and other major products, but non-major products could be sold on local markets (Perkins 2015, 42). However, this mixed economy did not last long; Mao Zedong abolished the remaining existing markets in agriculture in 1956 (Naughton 2007, 66-67; Wang 2000, 199-200), now forcing farmers to join collectives and adhere to plans. Only in the 1970s did some form of a market economy return to the countryside. As will be shown in Chapter II, the fact that markets were allowed to exist in the agricultural sector was key in pushing the reform strategy forward.

In terms of overall performance, it can generally be concluded that China's centrally-planned, heavy-industry economy was unsuccessful. It suffered most from lack of reliable data, which impeded the matching of targets to actual agricultural and industrial performance, and the failure of the planners to consider local differences. Naughton (2007, 56-57) argues that the industrialisation strategy was most successful during the first five-year plan (1953 – 1957), with industrial output rate averaging 11,5% annually. However, it can be questioned to what extent this really indicates success and economic health. The extensive focus on capital-intensive, heavy industry did not suit China's endowments, meaning that China's scarce resources were used for difficult undertakings it had no experience with, while it wasted the opportunity to explore its vast stock of labour power. By neglecting consumer goods sectors and squashing consumption and material incentives or rewards, people's living standards deteriorated (Ibid., 81-82). Even if the first five-year plan could be considered as economic progress, this was wiped out by Mao's Great Leap Forward (GLF) (1958 – 1961).

China's planned system rapidly took over the economy, but did not have an equally strong, commanding hold over every sector it covered. During some periods within the planned era, it could even be argued that China already mixed economic systems: an urban economy, in which the plan's authority was far-reaching and the government tightly controlled SOEs; and a rural economy, where the plan did not hold as much sway and some form of the market could exist. As the following two chapters will describe more in detail, these brief experiments with mixing economic systems enabled adherence to the reform strategy.

II. THE FIRST PHASE OF ECONOMIC REFORM: 1979 – 1992

It is generally accepted in the literature that the 3rd Plenary Session, held in December 1978, marked the beginning of China's transition process from a planned to a market economy (Lin, Cai and Li 1996; Naughton 2007; Perkins 2015; Wang 2000; Wu and Fan 2015). This session called upon the whole of China to "unite and work together … to build China into a modernised powerhouse of socialism" (Communist Party of China 1978). It aimed to focus the efforts of the party and the attention of the people on rapid socialist modernisation, for which economic reform – while maintaining political and social stability – was deemed necessary.

Having reviewed the characteristics of China's planned economy, this chapter and the next now turn to China's transition from the planned and controlled to the market-oriented and liberalised end of the spectrum of economic systems. Both will seek to clarify to what extent China's economy has been reformed: to what extent has it been liberalised, and to what extent has it been kept under control, since the beginning of 1979? It has been argued in the literature – most clearly by Barry Naughton[4] – that China's economic reform can roughly be divided into two phases. This chapter will analyse the first phase, running from 1979 until 1992. This phase is characterised by a gradualist, dual-track and decentralised approach, aiming to gradually move China's economy toward a market economy without rapidly dismantling and abolishing the

[4] Seeing as this study aims to provide a temporal assessment of China's economic transformation rather than a sectoral one, it sees Naughton's identification of two phases in the reform as most logical to follow. However, it must be noted that not every scholar whose works will be used here follow this reasoning.

planned economy. The analysis will be divided into four sections: the first will address the gradualist and dual-track approach that China pursued in this phase of reform; the second will analyse two developments that drove the reform strategy, which were already implemented during the planned period; the third will discuss the reform of the rural economy; and the fourth will examine the restructuring of the urban economy. Both this chapter and the next argue that the Chinese economy has been restructured in such a way to incorporate elements of a planned economy in a market economy, rendering the economy neither generally controlled nor generally liberalised.

II.I The Gradualist, Dual-Track Approach

Another aspect agreed upon in the literature is that China pursued a gradualist approach to economic transition, rather than the Big Bang approach taken on by Russia and former Soviet Union countries in Eastern Europe. These countries overthrew the socialist system at once and sought to move as fast as possible to a market economy. In contrast, the gradualist approach – or "walking across the river by feeling the stones" (Wang 2000, 9; Wu and Fan 2015, 57) – allowed China to gradually move towards a market economy without rapidly and radically dismantling the planned economy (Naughton 2007, 91-92). While Naughton (2007, 86-87) and Perkins (1988, 601) asserts that there initially was no blueprint for reform, Deng Xiaoping had endorsed the establishment of a dual-track economy, or the coexistence of a planned and market economy. China's market transition process would occur while upholding the planned economy, in order to avoid social and economic unrest and collapse (Wang 2000, 8-9). Deng justified this approach

and mixing of economic systems as it would preserve a balance between economic development, reform, and stability. Economic development was positioned as the solution to all of China's problems; reform was necessary to achieve economic development; but development and reform could only be guaranteed by social and political stability (Ibid., 33). As such, the market was gradually introduced, and the plan was gradually phased out.

According to the IMF, there is no consensus on which approach is better or more successful to pursue in transition economics, but China is the best possible example of a successful gradualist approach (Feltenstein and Nsouli 2003). The World Bank also acknowledged that there were clear lessons to learn from China's transition experience, although it did note that initial, pre-reform conditions in China differed from those in the former Soviet Union (World Bank 2002). Whether or not gradualism is the most successful transition approach, it became a successful strategy in achieving China's primary goal of the first phase of reform: a dual-track and decentralised economy, in which the plan protected core interests of the CPC in order to avoid unrest and instability, while other elements were gradually opened to the market.

II.II Reform Foundations: Administrative Decentralisation and Coexistence of Plan and Market

In achieving this goal, two developments undertaken during the planned period drove the first stage of reform: administrative decentralisation, and the coexistence of markets and plans. The first was implemented around the start of the Great Leap Forward (GLF), and the second came into existence once the disastrous consequences of the GLF were

known. These developments had most effect in the countryside, where the planned economy did not have as much influence as in the urban areas.

As touched upon in Chapter I, the SPC struggled to plan agricultural in- and output and productivity. In response, it engaged in administrative decentralisation in the late 1950s, to transfer control from the ministries and central planning level to local governments (Lin, Cai and Li 1996, 127; Perkins 2015, 50-51; Zimbalist and Sherman 198, 339). In the countryside, this led to the establishment of the Commune system, replacing the collectives. Like the collectives, the Communes were used to mobilise labour in agriculture and share local welfare but were now also granted local economic and governmental functions (Naughton 2007, 69). Rather than at the central level, agricultural planning policies were now coordinated and implemented by the Communes. Besides agriculture, Communes were also to develop and regulate rural industry, to rapidly upscale and expand industrialisation and modernisation (Wang 2000, 201). This was part of Mao's GLF strategy: he intended to develop small-scale rural industry next to the larger, more technologically advanced industry – the "walking on two legs"-policy – in order to catch up with the levels of industrialisation and modernisation of advanced countries (Naughton 2007, 70; Wu and Fan 2015, 57; Zimbalist and Sherman 1984, 339). Commune planners were to divert labour and land away from agriculture and allocate it to rural industry. However, the agricultural sector collapsed, and the rural population was reduced by millions[5] due to a period of extreme hardship and famine. This failure of the

[5] Official data is difficult to find.

GLF was exacerbated by poor weather in 1960, but mostly due to erroneous planning strategies. Yet, despite its disastrous consequences, the GLF-strategy did manage to consolidate the decentralised Commune system in the countryside.

In the 1970s, the Commune system was restructured, and with this, households were allowed private plots of land. The size of the Communes was reduced; management of land was decentralised further, from the highest administrative level of the Communes to lower levels; and rural industry could tend more to local needs. Additionally, households could now cultivate for the market or for private consumption (Wang 2000, 66-67; Zimbalist and Sherman 1984, 344). In other words, some form of market mechanisms and diversification of management and ownership – without it being privatised – came to coexist next to the plan. The institutional arrangements of the Chinese rural economy started to change. Consequently, economic reform from 1978 onward started in rural China.

II.III Rural Reforms: Household Contracts and TVEs

Experience with the type of decentralised planning and administrative management, and the introduction of some market forces alongside the plan, provided the basis for all-round rural development after 1978. The objective was to bring incentive and enthusiasm back to production, to increase economic efficiency (Lin, Cai and Li 1996, 126). In the rural areas, this meant that individual plots of land were contracted to households. While this required households to pay tax and committed them to turn over a certain amount of their grain harvest to fulfil government procurement quotas – secure

access to grain was one of the CPC's core interests – it simultaneously allowed them to do with the remaining output as they pleased. Households could sell it, for example, after which they were also allowed to keep the income received, rather than sharing it with the collective as previously required (Ibid., 131, 134). This policy spread rapidly throughout rural China; by 1983, this household contract system had replaced the Commune system (Naughton 2007, 90-91; Wang 2000, 67-68, 210-211; Wu and Fan 2015, 57). While this system did not render households fully autonomous in their economic decisions and ownership yet, it did gradually introduce market mechanisms to the rural areas.

Additionally, rural industry started to change. Under Mao, rural industries were small but capital-intensive and did not absorb much of the rural labour force. A sectoral "straitjacket" was imposed: rural industry was to engage only in iron and steel, cement, chemical fertiliser, hydroelectric power, and farm tools (Naughton 2007, 274-275; Song 2015, 186). However, during the 1980s, opportunities arose to change rural industry. As more agricultural products remained on local markets rather than being handed over to the state due to the household contract system, rural industry could engage in agricultural processing. The "straitjacket" was removed, and people increasingly set up collectively-, locally-run factories: the township and village enterprises (TVEs). Although these were collectively-owned, they were not covered by plans, because of which they could address every observed local problem or market need. As such, the TVEs were able to absorb the vast available labour, because of which they could increase rural economic efficiency and grow rapidly. They started to compete with the still tightly-controlled SOEs

in the urban areas (Naughton 2007, 90, 275; Wang 2000, 73; Wu and Fan 2015, 57), introducing and driving marketisation there (see section II.IV).

In all, experience with administrative decentralisation and some form of the market since the late 1950s became key drivers in propelling rural reform after 1978, first in agriculture and later in industry. These developments had paved the way for experiments with rural market decentralisation, changes in administrative management, and increased autonomy in resource allocation and production. Lin, Cai and Li (1996, 134) note an important consequence: after decades of neglecting its comparative advantage of abundant labour, China now started to make use of it and reap its benefits. The successes of the rural experience with reform would be used as example and foundation for reform in the urban areas.

II.IV Urban Reforms: SOEs, Dual Pricing, and SEZs

The influence of the planned economy had been weaker in the countryside than in the cities. Governmental control of SOEs was more pervasive than of agriculture: most of the state's core interests were produced by SOEs. Like in the rural areas, the approach for reforming the urban areas was gradual, but implemented less rapidly. This reform strategy was centred on three aspects, all of which were mutually complementary: reforming SOEs; implementing a dual-price system; and establishing Special Economic Zones (SEZs).

First, the need for reforming the SOEs was driven by the entry of, and increased competition from, TVEs and private and foreign firms. The existence of TVEs and small-scale private firms next to SOEs led to a diversification of ownership structures in China's economy (Naughton 2007, 301). See Table 2.4.1 on the next page. The data depicted here indicates that, from 1978 until 1992, SOE contribution to gross industrial output declined from 77,6% to roughly 50%, while that of collectively owned and foreign-invested and private enterprises increased. These changes reflect the loosening of government control on the industrial sector, allowing for a business environment in which enterprises with different ownership structures could compete. In this context, SOE reform revolved around two main aspects similar to rural reform: managerial reform, or the granting of more autonomy in administration and resource allocation, and reducing the predominance of the plan. Both aspects intended to enhance SOE efficiency, performance and competitiveness.

Managerial reform was preferred, as rapid and complete privatisation of SOEs – as was done in the former Soviet Union – was deemed too radical (Naughton 2007, 95; Wang 2000, 18-19). The reformers borrowed elements from the different ownership structures of TVEs and private firms, granting SOEs more managerial freedom and authority in order to enhance labour incentives to benefit economic efficiency. Additionally, a profit-retention scheme was implemented, through which enterprises were allowed to retain remaining profit after submitting a share to the state (Lin, Cai and Li 1996, 139). In 1983-1984, this scheme was replaced by a corporate tax system in order to better delineate the boundary between state income and enterprise income – the

Table 2.4.1
Share (%) of total gross industrial output value, per enterprise ownership

	1978	1980	1985	1990	1991	1992
SOEs	77,6	75,9	64,8	54,6	56,2	51,5
Collectively owned enterprises*	22,4	23,5	32,1	35,6	33,0	35,1
Other**	0	0	3,1	9,8	10,8	13,4

* Including TVEs
** Other referring to private enterprises and foreign-invested enterprises
Inspired by Naughton (2007) and Wu and Fan (2015).
Data calculated using National Bureau of Statistics of China, Yearly Data 1999[6]; http://www.stats.gov.cn/english/statisticaldata/yearlydata/YB1999e/m03e.htm

state would retrieve income from taxes and the enterprise from profits (Ibid., 141) – and between the roles of the state and the enterprises in the economy. Tax and fiscal reform will be discussed more in Chapter III, as it became more prominent during the second phase of reform. Simultaneously, more control over enterprise management and operations led to increased freedom in resource and labour allocation in the production processes. Plans were still assigned for some output, but additional capacity could be used to produce market goods (Lin, Cai and Li 1996, 125-126; Naughton 2007, 92). The authority of the plan in SOE operations was reduced. However, SOEs were not allowed to lay off redundant labour; workers remained protected by state-ordered plans and quotas (Naughton, 93, 181 – 184). Still, managerial reform and a reduction in the predominance of the plan led to SOEs, rather than the SPC or CPC, deciding on what products to

[6] Annual data between 1978 and 1990 not available, only 1978, 1980, 1985 and 1990.

produce and sell, which material incentives to experiment with, and how to use their own funds.

Second, the combination of TVE development and SOE reform gave way to the implementation of a dual pricing system. Reform had introduced some market forces to the economy, particularly the possibility for enterprises to engage in non-planned supply and demand. However, up to this point, prices were still set artificially by the SPC and did not reflect market forces. As enterprises were now allowed to produce and sell outside of the plan and were made more responsible for obtaining and allocating their resources, a dual-pricing system was implemented (Wu and Fan 2015, 60). State-fixed prices remained for products covered by the plans, and market-regulated prices could exist for products outside of the plan (Wang 2000, 11). The dual-pricing system had one positive and one negative effect. Positively, a growing variety of commodities entering the market led to a growing dominance of market prices and added new vitality and competition to economic life. This also illustrated some inefficiencies SOEs were still subjected to, such as loss-making due to artificially low state-set prices and high costs as a result of mandatory labour quotas. Negatively, the existence of dual prices created opportunities for corruption and opportunistic behaviour, as enterprise managers could now obtain goods at low state-set prices and sell them at high market prices (Perkins 2015, 52; Wu and Fan 2015, 60). Additionally, this system contributed to rising inflation. These problems opened possibilities for a new reform strategy, emphasising the institutional and regulatory framework (Chapter III).

Concurrent with SOE reform and the implementation of the dual pricing system was the opening of the protected industrial sector to external players. Opening to the outside world was a principal aspect in Deng Xiaoping's reform strategy; he asserted that the development of China should not be separated from the world, as the world and its development provide information, lessons and conditions to China's reconstruction. At the same time however, the existence and development of China should not be overlooked in the development of the world (Wang 2000, 323). Opening up was a way to draw on experiences, models and lessons from other countries, but also enabled China to show the other nations what it was capable of. This required reform of the foreign trade regime. Until the late 1970s, China's economy had been isolated from the world economy. Only 12 national foreign-trade companies (FTCs) were allowed to engage in foreign trade and flows of goods and money were heavily controlled. The value of the renminbi (RMB) was set arbitrarily and the currency was not convertible (Naughton 2007, 380). The only purpose of foreign trade was to import goods that could not be produced in China and to export non-essential goods in order to pay for imports. When, during the first phase of reform, China wanted to increase its technology imports, it found itself short of foreign exchange and unable to afford necessary imports without reforming the foreign trade regime.

Third, then, establishing SEZs was the first step in this process. These were first only established in the coastal and border areas – in order to learn and benefit from their proximity to Hong Kong, which was already a trading giant (Ibid., 382) – and later, when experience was gained, were granted access to the inland (Wang 2000, 11-12). SEZs

allowed China to gradually get used to export-processing and foreign direct investment (FDI). The SEZs were similar to the Export Processing Zones (EPZs) that had spread rapidly throughout Asia between the 1960s and 1980s, as they promoted export and earned foreign exchange without harming domestic industry. Investors allowed to operate in these zones were granted preferential policies, such as lower tax rates, simplified custom procedures and duty-free import of components needed for production (Naughton 2007, 406). Yet, China's SEZs were also different to other Asian EPZs in the sense that they were treated like governmental bodies on their own. They were allowed to retain much of the foreign exchange and tax and custom revenues that trickled in, in order to keep growing and transitioning to a market economy. Domestic industry was purposely adjusting to a market economy less rapidly than the SEZs, but the SEZs were to pass on advanced technology and diversified ownership and management structures inland.

SEZs were used as "windows on the world" in order to attract FDI and absorb experience with advanced technology and foreign business strategies (Naughton 2007, 382, 407-408; Wang 2000, 335). As such, by the end of the 1980s, there were 5000 state-owned FTCs and trading rights were granted to around 10.000 manufacturing enterprises, which all became increasingly occupied with market forces as profits, revenue and prices (Naughton 2007, 384). An additional benefit from demonstrating to the outside world that China would maintain an open economy in monitored zones, was that it enhanced credibility of its reform process.

II.V Successes and Shortcomings

In short, in the first phase of reform, the key challenge was to extract the economy from the institutions of a planned economy. The gradualist approach enabled China to slowly move away from the planned economy while introducing the market. Both rural and urban reform followed the same two strategies: gradually granting more managerial autonomy to farmers and enterprises, and gradually reducing the scope and dominance of the plan. This led to five institutional reforms, which all introduced some market mechanisms to the Chinese economy: (i) implementing the household contract system in the countryside, whereby households were still subjected to government procurement quotas for certain products, but were also allowed to produce and sell outside of the plan; (ii) allowing the development of non-SOEs, especially in the rural areas, which enabled rural enterprises to meet local demands not covered by the plan and drove competition and marketisation to the urban areas; (iii) expanding managerial autonomy of SOEs, in order to gradually make them more responsible for their own profits and production processes; (iv) adhering to dual-pricing, to get used to market-governed supply and demand; and (v) opening up to and learning from the global market by implementing SEZs.

These institutional reforms can generally be seen as a big step in the direction of a market economy, particularly as they led to diversification of the economy. Table 2.5.1 and Figure 2.5.1 illustrate this. Table 2.5.1 depicts the changing shares of total employed persons per economic sector. Development and modernisation of agriculture not only

Table 2.5.1
Share (%) of total employed persons in China during the first phase of reform, per economic sector

	1978	1980	1985	1986	1987	1988	1989	1990	1991	1992
Primary (agriculture)	70,5	68,7	62,4	60,9	60,0	59,3	60,1	60,1	59,7	58,5
Secondary (industry)	17,3	18,2	20,8	21,9	22,2	22,4	21,6	21,4	21,4	21,7
Tertiary (services)	12,2	13,1	16,8	17,2	17,8	18,3	18,3	18,5	18,9	19,8

Source: National Bureau of Statistics of China, Yearly Data 1999
http://www.stats.gov.cn/english/statisticaldata/yearlydata/YB1999e/e02e.htm

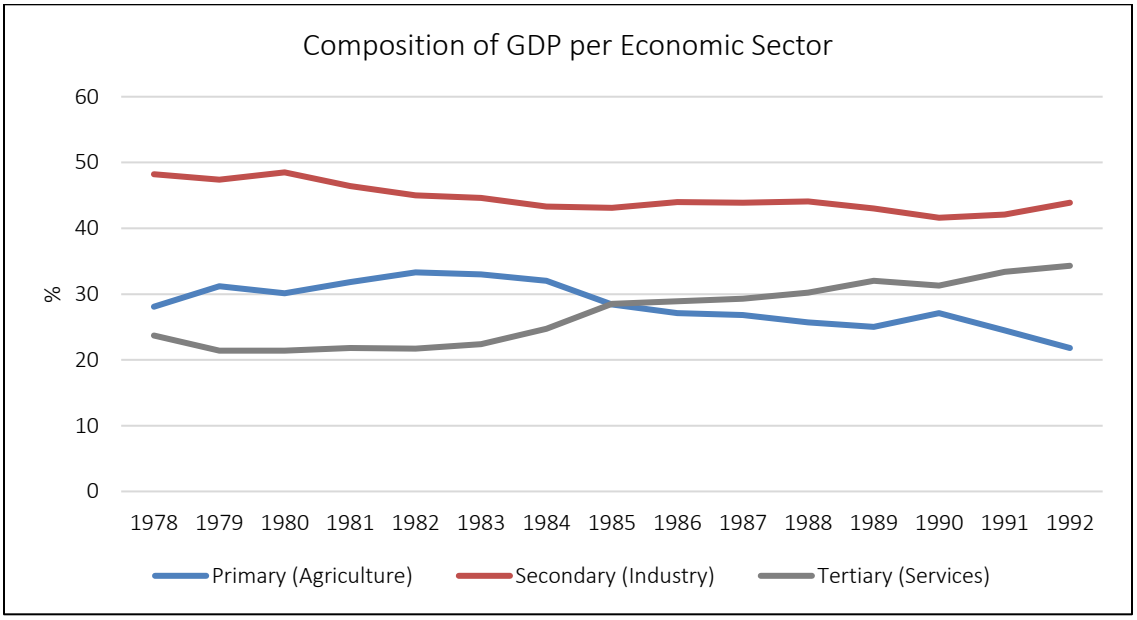
meant that output was increasing, but also that farmers could now take up non-agricultural jobs in the TVEs. The rapid decline of employed persons in agriculture between 1978 and 1992 depicts this rural reform success. The industrial sector has experienced the least substantial changes, most likely since SOEs still were not granted any rights regarding the hiring and firing of workers. In the second phase of reform, when the state sector would undergo a more rapid and thorough transformation, these labour protections would be eliminated (Naughton 2007, 107, 152). The service sector was neglected and repressed during the planned period, illustrated by the low share of 12,2% of employed persons working in services in 1978. As such, it could be expected that this sector would have undergone the most rapid change during the first phase of reform. While the tertiary sector grew gradually, what might have prevented a more rapid expansion could have been the larger effects that marketisation and diversification had on the primary and secondary sectors. The tertiary sector – and especially finance –

remained heavily subjected to governmental controls and closed off from foreign investment until 1992 (Wang 2000, 333).

Roughly the same diversification and development trends are depicted in Figure 2.5.1, illustrating the changes in composition of China's GDP by the three economic sectors. The slight increase in agriculture's share of GDP in the early 1980s represents the renewed priority given to agriculture during the first phase of reform. However, when rural and urban industrial reform started to accelerate from 1984 onwards, agriculture's share started to decline accordingly. However, the slow decline in industry's share depicts that this urban industrial reform occurred slower and more controlled than rural industry, as the data in Table 2.5.1 indicated as well. The developments in the primary and secondary sector gave way for a (controlled) rise in the share of the tertiary sector from the mid-1980s onward, when experience with reform was gained.

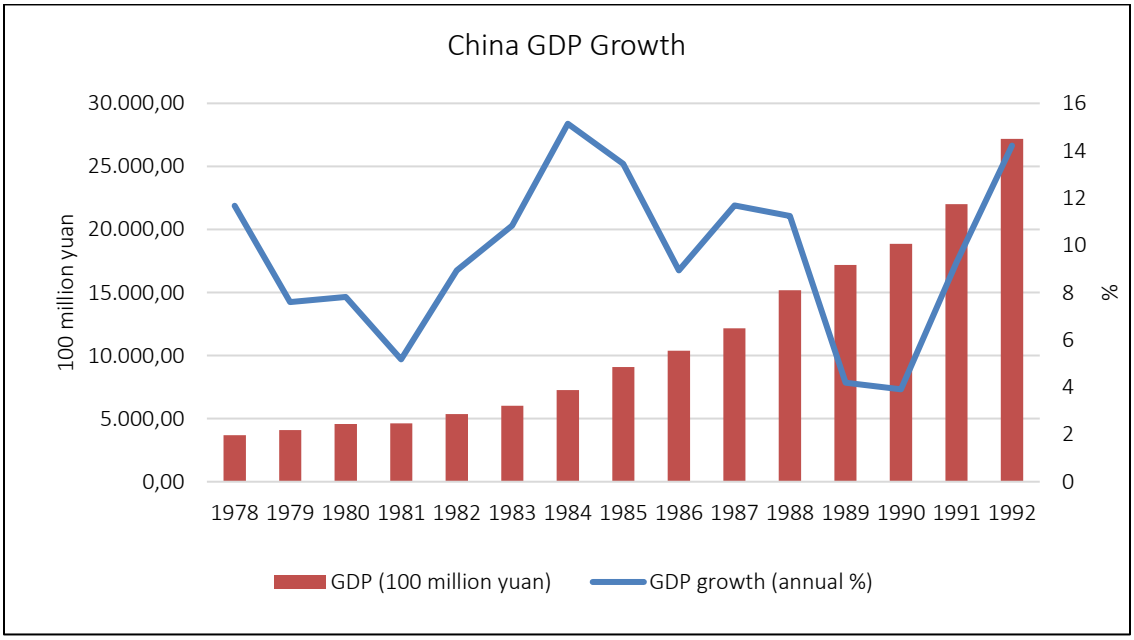
However, these institutional changes also exposed the incompatibilities of a market and a planned economy, especially in the macroeconomic environment. Figure 2.5.2 below exemplifies this: it illustrates the increase in China's GDP during the first phase of reform, combined with the instability of its growth rate. The high peaks indicate the successes of the reform measures, while the dips reveal the difficulty in adjusting to them. In other words, figure 2.5.2 shows that in transitioning to a market economy, macroeconomic cycles persisted throughout the reform process. These, in part, were the result of the incompatibility of maintaining a command economy while introducing a market economy. This "stalemate between the old and the new system" (Wu and Fan

Figure 2.5.1
Composition of China's GDP during the first phase of reform, per economic sector (in %)



Source: National Bureau of Statistics of China; Yearly Data 1999
http://www.stats.gov.cn/english/statisticaldata/yearlydata/YB1999e/c02e.htm

Figure 2.5.2
China GDP Growth 1978 - 1992, in 100 million yuan and annual % change



Source: National Bureau of Statistics of China, http://data.stats.gov.cn/english/ks.htm?cn=C01

2015, 61 – quoting a speech by Premier Zhao Ziyang), and more specifically, the existence of both market and planned prices, had led to two problems which were inciting resistance to the reform and slowing down its effects by the end of the first phase: corruption and inflation. In order to curb these two problems, a renewed reform strategy with strong emphasis on the macroeconomic environment was necessary.

III. The Second Phase of Reform: 1992 – 2003

The first phase of reform had centred on maintaining the planned economy while gradually introducing market forces. While this has led to economic successes, it also produced problems that required resolving outside of the institutions of the dual-track system. The second period of reform aimed to attain the objective of a "socialist market economy" (Naughton 2007; Wang 2000; Wu and Fan 2015) by ending the dual-track system, extending markets to all sectors of the economy, and implementing a fairer, more levelled, and better regulated competitive environment.

In keeping with examining to what extent China's economy has been liberalised or kept under control since the reform was initiated, this chapter will discuss this more thorough phase of economic reform by turning to one new, and one accelerated strategy. First, however, this chapter will turn to the political instability that emerged during the late 1980s and early 1990s, in order to provide an understanding of why the reform needed to be renewed and accelerated. The new approach identified macroeconomic control as necessary element. In the second and third sections, reform of the tax and fiscal system, and the banking sector and monetary policy will be analysed. Afterwards, in the fourth section, the accelerated strategy, which is applicable to SOE reform, will be discussed. In the second phase, emphasis was placed on clarifying the relation between the state and the enterprise, reforming the SOEs, and improving the business environment accordingly.

III.I Toward the Socialist Market Economy

As figure 2.5.1 of the previous chapter illustrated, reforming and growing the Chinese economy was no easy task. While early successes had given way to rising expectations about economic change and development for all, corruption and inflation were eroding these. Corruption fuelled public discontent with the government; inflation was biting into the rising incomes; and trying to curb inflation had led to the slowing of economic growth (see the decline in GDP growth in 1989-1990 in figure 2.5.1). Disillusionment with the reform strategy arose among the people and members of the CPC. Additionally, while opening to the outside world had enabled China to learn from the advanced countries, it also exacerbated the differences between a planned and a market economy and inflamed 'socialism vs. capitalism' debates within the CPC. This overall dissatisfaction eventually motivated social protest, culminating at Tiananmen Square in 1989 (Chow 2015, 130; Naughton 2007, 98-99; Wu and Fan 2015, 62). As a result, economic reform was halted.

However, in late 1992, during the 14th Congress of the Communist Party, the CPC established and endorsed – upon recommendations by Deng Xiaoping – a 'socialist market economy' as the objective of economic reform and development. A socialist market economy fitted Deng's theory of implementing "socialism with Chinese characteristics". Vogel (2011a, 465-466) explains that this essentially entailed stretching the party ideology to incorporate non- or less-ideological features and policies, so that, for example, socialism could encompass market reforms. From the beginning of the

reform, Deng had stressed that introducing market forces did not mean that capitalism would be practiced. He kept reiterating these views until the 14th Congress in order to convince the leaders of the CPC of the benefits of economic reform, and that these benefits should be placed outside of the capitalism-socialism dichotomy. He asserted that both the plan and the market were means to cultivating productivity and as long as they would further this objective, they should be used (Wang 2000, 39-40). Additionally, without the introduction of a market economy, it would not have been possible to have gained access to information and technology of the advanced economies (Wu and Fan 2015, 62-63). Indeed, during the 14th Congress, Jiang Zemin, Secretary General of the CPC, affirmed that "according to conventional thinking, a market economy is peculiar to capitalism, and a planned economy is the basic feature of socialism … We have gradually freed ourselves from those conventional ideas … and should state that the objective of the reform of the economic structure will be to establish a socialist market economy" (Jiang Zemin 1992). With the tension of choosing between and adhering to a capitalist or a socialist system now alleviated – at least within the party leadership – economic reform could recommence and accelerate.

A socialist market economy meant that "market forces, under the macroeconomic control of the state, serve as the basic means of regulating the allocation of resources" (Ibid). In other words, macroeconomic *management* of the economy would be coordinated by the market, but it would remain subjected to governmental *control*.[7]

[7] See Wu and Fan (2015, 59). This strategy was based upon Janos Kornai's analysis of which economic system would best fit socialist countries trying to reform. In his opinion, a system in which the market would coordinate, while the

Markets were to extend beyond capital and consumer goods to finance, technology, labour, information, and real estate (Jiang Zemin 1992; Vogel 2011b, 685). As such, with the government in need of strengthening its regulatory and macroeconomic control, but in an economy suffering from corruption and inflation, the following two reforms were needed: macroeconomic control, in which the government would have to impose contractionary fiscal and monetary policies to counteract inflation and overheating and reform the tax and financial systems (Wu and Fan 2015, 60); and the changing of government functions in relation to SOE functions. Both reforms emphasised the improvement of the institutional and regulatory environment, because of which the second phase of reform introduced a more thorough and rigorous way to economic transition.

III.II Macroeconomic Control: The Tax and Fiscal System

By the mid-1990s, China was showing signs of a fiscal crisis. The SOE reform incited in the 1980s had produced two effects harming the government budget. First, in order to adjust to and stimulate SOE profitability and dynamism in face of increased competition from TVEs and other enterprises, the government was running an expansionary fiscal policy (Wu and Fan 2015, 62). However, this had produced economic overheating. Second, with the intention of rendering SOEs more responsible for their own profits and losses, the profit-retention scheme implemented in the early 1980s had resulted in SOEs handing

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government would still exert control over, the macroeconomic environment would be the best option. Government coordination, rather than market coordination, would erode economic incentives and stifle growth; but the market could not be given full autonomy either, as it has its own weaknesses.

over less of their profits to the government. These two combined were responsible for a decline of government budget as a share of GDP. In fact, with an expansionary policy but declining budget, the government was running into deficits and would resort to the banks for the financing of government activities (Naughton 2007, 429-430). With a tax system virtually nonexistent, the government's budget running deficits, and overheating and inflation because of the expansionary policy and dual-pricing system, the banks increasingly became the central actors in maintaining macroeconomic stability. As the 14th Congress called upon the government to strengthen its macroeconomic functions, a revival of the government's budget was necessary, which gave way to tax and fiscal reform.

Rigorous fiscal reform started in 1994 with the implementation of new taxes and a tax sharing system. As discussed in section II.IV, a corporate tax system was implemented in the mid-1980s as a pilot, to eventually replace the profit-retention scheme. While this was a step in the right direction of making way for market forces and creating a fairer competitive environment, it was prone to abuse and evasion. This tax system essentially meant that each enterprise had an individual tax contract with the government (Ibid., 94). As the tax rate was specific to each individual enterprise, and with underdeveloped accounting and auditing practices in place, enterprises could relatively easily find ways to evade taxes and increase their own incomes at the expense of the government's tax revenues (Lin, Cai and Li 1996, 142-143). In response, the government enacted fiscal reforms in 1994. A 17% value-added tax (VAT) was now levied on most manufactured goods; a 33% profit tax with equal rates for all enterprises – state-owned,

collective, and private – was introduced; a consumption tax on luxury products was implemented; and the previous corporate tax contracts and remaining SOE profit-retention schemes were abolished (Naughton 2007, 432). The central government would claim revenues from the luxury tax, customs duties and taxes on sectors controlled by the central government (i.e. financial institutions, rail roads, and large enterprises), whereas the provincial governments had control over taxes on local enterprises. The revenue generated from VAT would be shared: the central government could claim 75%, whereas provincial government would obtain 25% (Naughton 2007, 433; Wang 2000, 381; Yu 2015, 148). A new central government tax agency would oversee and control all these processes.

The effects of this tax reform were twofold: it standardised the income relationship between the central and local governments by balancing their financial powers and eliminating arbitrariness in the distribution of fiscal revenues among different levels of government; and it strengthened the central government's ability to control the macroeconomic environment as its budgetary revenues were stabilising and rising from 1996 onward (Wang 2000, 380). Consequently, the expansionary policies that had characterised the 1980s in support of economic growth could be reined in. During the second phase of reform, budgetary deficits were generally modest. Only after 1998, with unemployment rising due to accelerated SOE reform (discussed in the next section) and effects from the Asian financial crisis did China implement expansionary fiscal policies again (Naughton 2007, 441; Yu 2015, 140), but these were reverted after 2002.

In fact, Yu (2015, 149) finds that China would only "spend its way out of trouble" again in the aftermath of the 2008-2009 financial crisis, when it enacted a large stimulus package.

III.III Macroeconomic Control: The Financial Sector and Monetary Policy

Reforms in the tax and fiscal system played into reforms in the financial system, and especially in the heavily protected and regulated banking sector. During the planned period, the banks' sole task was accommodating the credit flows to the enterprises, which were set and ordered by the planners. Other financial institutions, markets and services did not exist; the banking system was – and still is – the dominant actor in China's financial system (Naughton 2007, 449, 451; Yi and Guo 2015, 236). Similarly, monetary policy was in hands of the government, consisting only of allocating loan quotas and cash management plans to the banks (Yu 2015, 247). As briefly touched upon in section III.I, the banks became more important during the first phase of reform: the more resources that were being allocated by the market and were bought and sold with market prices, the more prominence the banking sector attained (Yi and Guo 2015, 235; Yu 2015, 143). In 1984, the People's Bank of China (PBC) became the central bank and, with the creation of four state-owned specialised banks, a commercial banking system was established. Concurrent with SOE reform, bank loans started to replace governmental financial allocations to SOEs. Enterprises would borrow from banks to finance their needs and would pay interest, rather than being dependent on governmental allocations at no cost. However, these loans were still being ordered and funded by the state. Additionally, with household income growing and savings increasing,

more money flowed into the banks that could be made available for investment. This abundance of cash was appealing for the government to tap into for their own objectives, such as saving loss-making enterprises and protecting their workers, propping up the SOE sector in face of increased competition, or funding policy objectives. These activities led to a large build-up of non-performing loans (NPLs) in the 1990s and prevented banks from becoming truly commercial (Naughton 2007, 453; Yu 2015, 237).

Again, from 1994 onwards, reforms were incited. Policy banks were established, separate from the state-owned commercial banks, to alleviate political pressure on commercial banks to undertake politically popular projects. Additionally, the central bank became stricter in its provision of credit to the four commercial banks, improving their autonomy (Naughton 2007, 454-455; Wang 2000, 420-422). Yet, full recognition of the problems associated with the burdened banks – particularly their inability to generate their own funds and overturn their unhealthy balance sheets – was brought up by the Asian financial crisis in 1997. The banking sector needed a substantial inflow of resources for crisis to be averted. The government began efforts to recapitalise the banks in 1998, with the most important aspect being the establishment of four state-run assets-management companies. These companies bought NPLs from the state-owned commercial banks at a total value of RMB 1,4 trillion (Naughton 2007, 104, 462; Yu 2015, 237). Larger bailouts were necessary but problematic, as these risked demotivating the banks to set harder budget constraints and to bear responsibility for their lending decisions. Thus, further recapitalisation efforts were enacted, but preconditioned on efforts such as introducing market discipline, strengthening internal control, adopting

thorough accounting standards, and increasing transparency (Naughton 2007, 463-464; Yu 2015, 237-238). These conditions became especially important in the context of China's accession to the World Trade Organisation (WTO) in 2001, calling for a fairer and more transparent financial and business environment.

As a result of these reforms in the financial sector, though they were slow and difficult, the objectives of monetary policy changed. With the planned economy largely phased out, monetary policy switched from allocating cash management plans to promoting economic growth and maintaining price and exchange rate stability[8] (Yu 2015, 144). The first step towards price stability meant dealing with the dual-pricing system. However, the Chinese government did not actively implement policies to change this system. SOEs increasingly preferred to buy, produce and sell at market prices in order to improve their productivity and competitiveness, which the state allowed for by gradually lifting control of more and more goods and prices previously set by plans (Perkins 2015, 52; Wang 2000, 11). As such, the dual-pricing system came to an end in the early stages of the second phase of reform. With most prices now governed by market forces rather than set by plans, price stability could be handled more effectively. Nevertheless, the government still sets prices for several public products and services that have "an important bearing on the national economy and the people's livelihood" (Wang 2000, 165).

[8] In these objectives, another important objective was interest rate liberalisation, but this was only formally set as a goal after 2003. Therefore, it falls outside the scope of this chapter. See Yi and Guo (2015) for more information.

Then, in order to curb inflation, monetary policy in the late 1980s and 1990s mainly consisted of an administrative and an economic means. Respectively, the government would order and issue credit quotas to banks, which were not to be exceeded; and the banks would raise interest rates on deposits to stimulate people to put their money in the banks, whereby the quantity of money in circulation could be reduced and the price level lowered (Chow 2015, 130-131). With these policies, inflation was controlled and price stability attained by the end of the 1990s. Facing effects of the Asian financial crisis in 1998, especially the slowing of economic growth, the Chinese government resorted to expansionary fiscal policy by increasing their expenditure to raise demand, rather than loosening the money supply and increasing credit (Chow 2015, 132; Yu 2015, 149). During and after the reform, the Chinese government started to respond to macroeconomic business cycles with expansionary of contractionary monetary and fiscal policy; in case of overheating, monetary tightening would cool down and stabilise the economy, after which expansionary fiscal or monetary policies would be used to pick up economic growth again. Although the government still had a strong hold over the banks and monetary policy, it responded to macroeconomic challenges like most market economies.

Exchange rate stability became increasingly important as part of monetary policy as Chinese exports and trade grew in the 1990s. During the first phase of reform, fitting the gradual approach, a dual-exchange rate regime was maintained. Exporters in the SEZs operated outside the plan and could sell at the lightly regulated market rate, instead of at the official but heavily regulated planned rate, because of which exporting became

profitable (Naughton 2007, 383). Additionally, imports were increasingly shaped by world prices instead of being converted to governmentally determined prices (Wang 2000, 150), adding to the gradual phasing out of the dual-pricing system,

During the second phase of reform, two aspects in reforming the exchange rate regime were important. First, in 1991, the official exchange rate shifted from fixed to a managed float, and in 1994, the market and the official rates were merged. This signalled a unified exchange rate regime (Yi and Guo 2015, 245-246; Yu 2015, 150) and the attainment of current-account convertibility (Naughton 2007, 389). Second, a unified exchange rate and current-account convertibility were important as large amounts of foreign exchange, acquired through trade and inflow of FDI, had been trickling in since 1992. The unified and managed floating exchange rate and current-account convertibility facilitated import and export transactions, because of which China was able to expand its international trade. From 1992 onwards, the tertiary sector was finally opened up to foreign investment. FDI flowed in rapidly, mainly from Hong Kong and Taiwan, in services as finance, insurance, accounting, and information (Wang 2000, 334). Until then, China had been building international credibility with foreign investors by gradually opening up and building the institutional infrastructure, but had not allowed for the tertiary sector to be opened up to outside investors yet. Although the Tiananmen Square crisis initially turned investors away because of the uncertainty it imposed on the direction of the reform, the CPC's commitment to a socialist market economy in 1992 relieved this anxiety (Naughton 2007, 403). With a unified exchange rate regime and current account

convertibility, China signalled a commitment to an open economy, liberalised foreign trade, and fair treatment to exporters and foreign investors.

However, the Asian financial crisis somewhat overturned the positive changes China had initiated since the mid-1990s. Instead of maintaining a managed float and allowing the currency to depreciate like many other Asian currencies, China pegged the renminbi to the US dollar (Naughton 2007, 389; Yi and Guo 2015, 245-246; Yu 2015, 150-151). Nevertheless, China's accession to the WTO in 2001 slowly pushed China back towards a managed float exchange regime. Following rapid economic and export growth, a large trade surplus and reserve of foreign exchange were built up. This, against a relatively low but fixed value of the renminbi, caused the United States to pressure China to give up the peg, which happened in 2005 (Chow 2015, 133; Naughton 2007, 389; Yi and Guo 2015, 246; Yu 2015, 151). It is likely that, had China not pegged the renminbi to the dollar, it would not have come out of the Asian financial crisis as unharmed as it did now.

This analysis of the changes incited in the fiscal and financial dimension of China's economy indicate that these have also adapted to China's gradual transition toward a market economy. These changes were mostly oriented toward strengthening the government's ability to control the macroeconomic environment and putting in place a rigid macroeconomic policy environment. Yet, these were also meant to remake the institutional setup of the Chinese economy by making it more compatible with that of a market economy. As such, the newly enacted macroeconomic policies enabled the

establishment and enhancement of fairer competition among an increasing number of players. The other step in achieving this was reforming the relation between the Chinese government and its SOEs.

III.IV Changing the State-SOE Relation

Changing the operations of SOEs, and changing the functions of government accordingly, were two tasks identified during the 1992 14th CPC Congress as necessary in establishing a socialist market economy. According to Jiang Zemin, as reported during the Congress, enterprises should be turned into "legal entities responsible for their own decisions about their operations and expansion and for their own profits and losses" and the government, whether central or local, should refrain from intervening in areas in which control would be handed over to enterprises (Jiang Zemin 1992). As the macroeconomic reform had put in place fiscal and monetary policies that rendered the competitive environment more levelled and better regulated, opportunity arose to push more SOEs into the market, in order to increase the vitality and dynamism of SOEs, and the economy in general. Creating and regulating competition to stimulate economic change and transition became a more important governmental function than directly intervening in and managing the enterprises' operations (Naughton 2007, 103). Whereas the first phase of SOE reform emphasised the granting of more managerial autonomy and freedom in economic decision-making, the second phase focused on "corporatising" the enterprises (Ibid., 298): downsizing and privatisation of the state-owned sector, and improving corporate governance were key aspects.

In terms of downsizing, the big difference between the first and second stages of SOE reform was that in the second stage, SOEs were granted more rights regarding the hiring and firing of labour. Until 1992, SOEs were not allowed to lay off redundant labour as guaranteed employment was seen as imperative in maintaining social stability throughout the economic transition process (Ibid., 181–184). When SOEs were given more autonomy over their labour, between 30 and 50 million SOE workers were laid off over the course of 10 years in order to cut burdens and improve performance (Naughton 2007, 184-186; Song 2015, 184, 187-189).

Privatisation of enterprises became more acceptable as the share of enterprises with different ownership structures grew (as table 2.4.1 in Chapter II indicated). However, with the lines between different ownership structures now gradually being blurred, the government adopted a new policy of "grasping the large, letting go of the small". The largest SOEs – those most important to the economy, such as those concerned with energy and natural resources – would remain centrally-owned and were reorganised and merged into even larger enterprises, while local governments were granted authority to privatise or shut down small and medium-sized enterprises (SMEs) (Naughton 2007, 301-302; Song 2015, 188). Downsizing and privatisation coincided with the reform of the banking sector and the macroeconomic austerity imposed in the second half of the 1990s. With the government issuing the state-owned banks credit quotas as part of tightening money circulation, it also signalled to the SOEs that it was willing to let non-performing, loss-making firms fail. The largest and most important SOEs remained protected by the state and the state-owned banks, but other enterprises, and

especially SMEs, were forced to be concerned with their own profitability. Enterprises downsized or shut down either as a result of the firing of abundant labour, of the macroeconomic conditions of the late 1990s, or both. Consequently, the total number of industrial SOEs dropped from 103,300 in 1992 to 29,400 in 2002. See table 3.3.1 below.

Table 3.3.1
Number (in 10,000 units) of Industrial Enterprises per Ownership, 1992 – 2002

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
State-Owned	10.33	10.47	10.22	11.80	12.76	11.10	6.47	5.06	4.24	3.45	2.94
Collectively Owned								4.26	3.78	3.10	2.75
Limited Liability								0.97	1.32	1.90	2.25
Private							1.07	1.46	2.21	3.62	4.92
Foreign Funded							1.07	1.11	1.20	1.32	1.49

Source: Compiled from Yearly Data 1999, 2000, 2001, 2002, and 2003. National Bureau of Statistics of China[9]

Besides the dramatic reduction in SOEs, table 3.1.1 also depicts a strong rise in private enterprises. This was in part a consequence of the more flexible hiring and firing regime; the state was required to loosen their restrictions on the private sector, so that this sector could absorb the available labour (Song 2015, 191). Indeed, in face of rising unemployment, the government was also forced to become concerned with

[9] This data is based on enterprises with ´above designated size', meaning it is only concerned with enterprises with annual revenues of more than 5 million yuan. Additionally, the data was adjusted in 1998, when statisticians only started collecting data on these enterprises (Naughton 2007, 302), because of which the data before 1998 on all other enterprises but state-owned ones becomes unreliable.

reemployment services and social security. In 1998, the Ministry of Labour and Social Security was created and Reemployment Centres (RECs) were established, in order to keep better track of unemployment, channel laid-off workers into the RECs, and take care of social security and welfare provisions (Naughton 2007, 186). However, the private sector also became increasingly important in the state's privatisation effort. With non-performing SOEs now allowed to fail, the private sector would increasingly acquire these enterprises, not only to preserve jobs, but also to add to the market orientation of "non-core" industries (OECD 2005, 80; Song 2015, 191-192). Note that the growth of private ownership was mostly limited to the industrial sector, for three reasons: SOEs dominated the industrial sector; agriculture was already largely privatised; and control over services – especially banking and finance – was only given up very slowly.

Another aspect that stands out from table 3.1.1 is that the decline of SOEs coincided with a rise in limited liability companies (LLCs). This was a result of the implementation of the Company Law in 1994, which is seen as a key step in improving corporate governance in China (JiangYu Wang 2014a, 6; Naughton 2007, 104). The objective of the law was to "standardise the organisation and activities of companies [and] to protect the legitimate rights and interests of companies, shareholders and creditors" (Company Law 2005, Art. 2; JiangYu Wang 2014s, 6). As such, the Law provided a framework for converting SOEs into legal entities, either as joint-stock corporations or LLCs (Naughton 2007, 104, 301, 314). Other forms of business organisation were not recognised (Company Law 2005, Art. 2). This conversion continued the process of reducing state ownership: once an enterprise was converted, it could diversify its

ownership by selling its shares. Joint-stock corporations would have more than one, but no more than 200 shareholders, with shares equally divided among them. Liability for the company would thus be limited to the number of shares one held. LLCs would have to be invested in by more than one, but no more than 50 'shareholders' – LLCs did not actually issue shares, but investors were still called shareholders (JiangYu Wang 2014b, 53) – with its capital made up of contributions that were not equally shared but agreed upon in percentage holdings. A shareholder's liability to an LLC would then be limited by his contribution (Company Law 2005, Art. 3, Art. 24, Art. 78; JiangYu Wang 2014b, 50-51). Additionally, the Law further clarified the functions of corporate managers and owners and established a system of better oversight and governance in order to tackle corruption. Effectively, the Company Law indicated that the state issued a legal framework in which any form of enterprise ownership could operate, thereby signalling a commitment to levelling the competitive playing field.

However, it should be noted that although SOEs were converted and their ownership was diversified, the state could still partly or wholly own these corporations. For example, in 2002, there were approximately 22,500 LLCs, of which 1,349 were fully owned and funded by the state[10]. Put differently, the fact that companies were no longer explicitly designated as state-owned did not mean that they were now privately-owned (OECD 2005, 80). Therefore, it is difficult to conclude in what way the decline of SOEs corresponds to an actual decline of the state-owned sector. Still, as JiangYu Wang argues

[10] No data could be found on how many LLCs and joint-stock corporations were partly funded or owned by the state (National Bureau of Statistics of China 2003, 459).

(2014a, 27), with the implementation of the Company Law and the transformation of Chinese enterprises into legal corporations, these did not differ as much from their Western counterparts – at least not in their legal status, rights, and requirements.

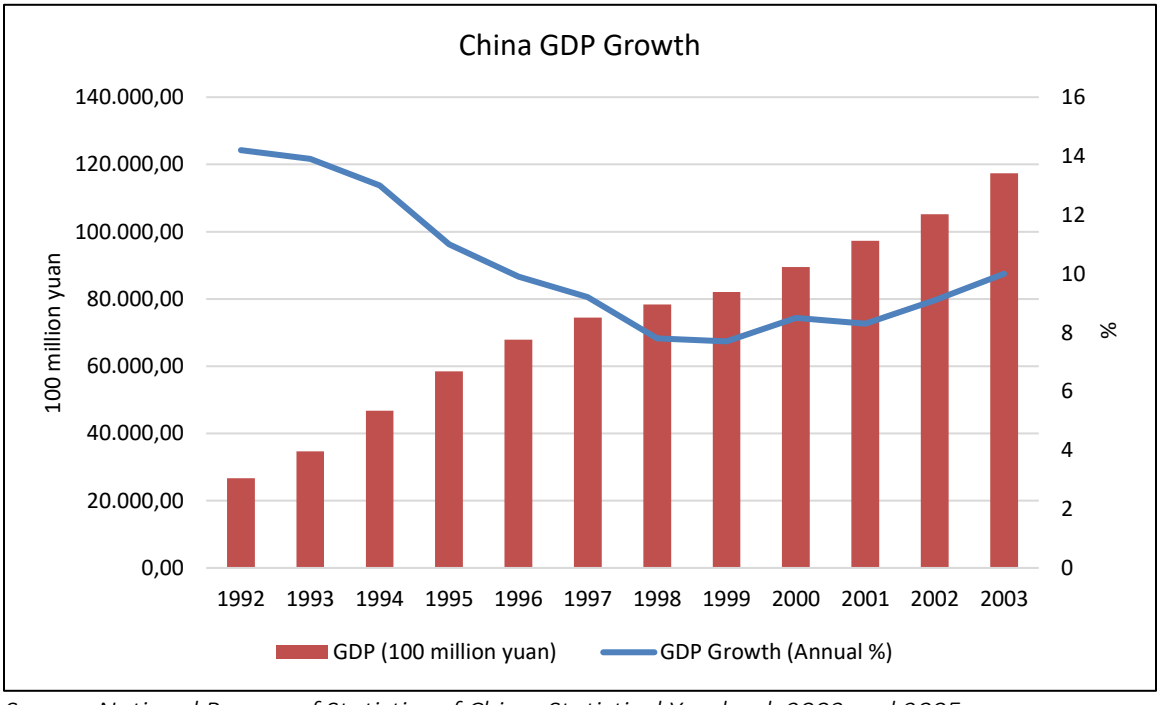
III.V Successes and Shortcomings

In uncovering to what extent China's economy has been kept under control and to what extent it has been liberalised since 1979, this chapter and the previous one have illustrated that the Chinese economy has been restructured in such a way to encapsulate elements of socialist planning into a capitalist market economy. Consequently, the Chinese economy is neither generally planned and controlled, nor generally liberalised and open. The purpose of the first phase of economic reform was to gradually get used to mixing economic systems. By the mid-1990s, China's economy had grown out of the characteristics and institutions of a planned economy. The dual-track system of maintaining a planned economy while introducing a market economy was largely phased out: dual-pricing was eliminated, except for goods that are in the core interest of the CPC; the dual exchange rate was ended; and the dominance of the plan had given way to the market. However, this is not to say that the institutions governing China's economy from the mid-1990s were fully compatible with those of a market economy. Naughton (2007, 85) even argues that the second phase of reform is far from complete, as further institutionalisation is necessary.

On the one hand, it could be argued that the Chinese government has put substantial effort into transforming the Chinese economy to a functioning market

economy, as evidenced by reforming its fiscal and financial system; responding to macroeconomic cycles in similar fashion as market economies; reducing, or even giving up, its control of SOEs, and regulating and improving the business environment and corporate governance. On the other hand, it could be said that governmental control over the economy has become more covert, as indicated by the blurred and hybrid ownership structures of joint-stock corporations and LLCs, and the continued hold over the banking and financial sector. In short, then, the Chinese government continues to mix economic systems, by using the elements from both a capitalist market economy and a socialist planned economy that serve its needs and interests. As such, the economy cannot generally be considered a market economy, nor a planned economy.

Figure 3.5.1
China GDP Growth 1992 – 2003, in 100 million yuan and annual % change



Source: National Bureau of Statistics of China, Statistical Yearbook 2003 and 2005. http://data.stats.gov.cn/english/ks.htm?cn=C01

Still, fact remains that the second phase of economic reform had provided a stable macroeconomic environment; increased marketisation and competition in the industrial sector, which were accompanied by improved regulations; and accelerated the opening to the global market, in part as a result of China's accession to the WTO. These factors had led China to embark on a path of rapid economic growth. See figure 3.5.1 on the previous page. Although GDP growth slowed in the mid- and late-1990s – due to macroeconomic reform, more thorough and rapid SOE reform, the downsizing of the state sector, and the effects of the Asian Financial Crisis – the annual growth rate only briefly dipped below 8% and quickly regained double digit rates. Yet, opportunities for further reform in the 21st century exist, especially in relation to the macroeconomic environment and legal and regulatory frameworks. The next chapter will analyse these opportunities and relate them to the larger question of whether China will be able to continue its economic growth in the 21st century, or not.

IV. GROWING OR SLOWING? CHINA'S ECONOMY IN THE 21ST CENTURY: CONSEQUENCES, CHALLENGES, OPPORTUNITIES

It is evident that China's economy would not have attained the global power and size it currently enjoys had the CPC not initiated economic reform 40 years ago. However, the economic growth that facilitated this global position has not come without looming consequences and two serious challenges. Whereas spectacular economic growth characterised China's performance during the first decade of the 21st century, the durability and sustainability of this growth is now being questioned in the second decade of this century. Further reform might mitigate these challenges, but might prove difficult to implement as most economic policy changes span international and domestic political, societal, and economic dimensions.

Will China's economy be able to continue to grow, or will it slow down? This question has framed our research so far, but has not been addressed directly yet. This chapter will discuss it in more detail and attempt to answer it. The first section will provide an analysis of the main consequences of China's rapid economic growth, and the second will do the same for the challenges it is now facing. The third will highlight opportunities for further reform that may mitigate these challenges and further economic growth.

IV.I Consequences: The Turning Point in Economic Development

As one of the first scholars of this phenomenon, Ross Garnaut asserted in 2006 the main consequence of China's rapid economic growth was fast approaching: the "turning point in economic development" (Garnaut 2006, 1-2). This theory, coined by W. Arthur Lewis, holds that a developing country will reach a 'turning point' in its economic history when cheap surplus labour from the rural sectors dries up and forces wage increases, because it can no longer fuel rapid industrial growth in urban areas (Ibid)[11]. Put differently, as an economy grows and develops, the large share of unskilled workers in agriculture tends to decline as they move towards the more productive industrial, urban sector (Cai and Wang 2010, 319; Golley and Meng 2011, 563). This allows for rapid growth of the industrial sector without increasing labour costs, as the supply of unskilled workers is larger than the demand. This was especially true for China. However, as surplus labour begins to run out and demand begins to exceed supply, wages of unskilled workers in the industrial sector will have to rise as well. This forces industrial upgrading and change toward more capital- and technological-based industry, as higher wages will drive higher production costs and may undermine the competitiveness and profitability of labour-intensive industry (Garnaut and Huang 2006, 18-21; Golley and Meng 2011, 556).

In Chapter II of this research it has been noted that the reform strategy's success was initially based on China finally being able to make use of its comparative advantage of abundant labour. In the 1980s, the TVEs readily absorbed surplus labour in the rural

[11] Garnaut (2006), Garnaut and Huang (2006) and Golley and Meng (2011) explain the theory in detail.

areas, and with more thorough urban SOE reforms occurring during the 1990s, workers started to move to the cities by the millions. In 2000, 78,5 million people migrated from the countryside to the urban areas, growing to 145 million in 2009 (Cai and Wang 2010, 323-324; Du and Yang 2014, 624).

However, some scholars, among which Cai and Wang (2010, 321-322, 325), Garnaut and Huang (2006, 19), and Zhao and Huang (2010, 6) pinpoint 2004 as the year in which the turning point began, as the first signs of migrant labour shortages appeared in China's dynamic and competitive coastal areas. This started a debate in the literature as to whether China has indeed reached its turning point or not. Those that do not believe that China has reached its turning point criticise the incorrect, flawed and biased data of the studies of scholars that do believe the turning point has emerged (e.g. Golley and Meng 2011). In contrast, those supporting the hypothesis that China reached its turning point acknowledge that poor quality of data impedes the exact pinpointing of when the turning point was reached and concur that related signs – a labour shortage and rising wages – may be temporary, but do send the message to investors that the flow of unlimited and cheap labour is running against its limits (e.g. Garnaut and Huang 2006).

Nevertheless, according to Lewis' theory, if surplus labour would dry up, an increase in real wages would be noticeable. This research agrees with Golley and Meng (2011) that it would be most relevant to look at wage increases for China's migrant workers, as they make up the class of surplus labour. Urban workers tend to be more skilled and better educated, and migrant workers are often only allowed to take up low-

skilled jobs with lower wages. Examining the period 2000-2009, Golley and Meng found that real wages of migrant workers only increased in 2005 and 2006, but for reasons related to international and domestic policy decisions – respectively, the low-skilled, labour-intensive textile industry grew rapidly from 2004 onwards, as the United States lifted their restrictions following China's WTO accession (Golley and Meng 2011, 561); and the Chinese government's decided to raise minimum wages (Das and N'Diaye 2013, 5) – rather than as a result of labour shortages. Other evidence of wage increases for migrant workers do exist, but these have been offset by increases in living costs in the urban areas, because of which *real* wages have not or barely increased (Golley and Meng 2011, 562). In terms of the drying up of unskilled labour, they found that China's pool of surplus labour is larger than assumed by other studies, but the flow of these migrant workers to the urban areas is impeded by institutional restrictions. Thus, they refute claims that China is running up to its turning point in economic development (Ibid., 567-568).

However, this research also acknowledges the difficulty of other studies (e.g. Cai and Wang 2010) in sampling the right data. Indeed, several institutional restrictions and poor quality of and access to data impede a thorough analysis of the extent to which China's pool of surplus labour is declining. For instance, from the establishment of the PRC onwards, the Chinese government imposed certain policies to stem migration from the countryside to the cities, such as internal barriers to the movement of people (the *hukou* system) and restrictions to social security, healthcare, and pension for rural migrants working in the cities (Garnaut and Huang 2006, 18; Golley and Meng 2011,

555). Consequently, rural migrant workers are often not included in official data and household surveys, impeding an analysis of wage rises and labour shortages.

What this shows is that signs of a turning point in China's economic development are difficult to discover and should not be judged independently of domestic and international policy decisions. Another factor that should not be overlooked are the sentiments of rural workers. For example, since 2004, rural workers have become more hesitant to migrate to the cities because of the poor working and living conditions they would face (Zhao and Huang 2010, 6). Expectations of better socio-economic conditions and a more rewarding nature of work have gained more traction since 2009 when, after millions of workers in labour-intensive industrial sectors were laid off as a result of the global financial crisis, demand for labour surged again (Ibid.). Additionally, China's demographic realities should not be ignored either. It is projected that China's working age population (between 15 and 64 years) has stopped growing since 2015 and will turn negative by 2020, all the while its total population size is declining (Cai and Wang 2010, 320; Das and N'Diaye 2013, 7). Indeed, the IMF deems China's demographic reality "the dominant force driving the depletion of surplus labour" and predicts that the turning point will emerge between 2020 and 2025 (Das and N'Diaye 2013).

In all, perhaps a more efficient approach for analysing and interpreting change in China's labour markets would be to look out for phases, rather than one definitive turning point. Zhao and Huang, for example, identify the aftermath of the global financial crisis as a *second* wave of labour shortage in China, with the one in 2004 being the first

wave. Although the IMF still expects a turning point to emerge, they treat labour shortages as “episodic”, rather than one definitive moment. As such, in general, looking for one turning point might be a futile exercise. China’s economy might be too large and diverse to identify one exact turning point; domestic institutional restrictions and poor quality of and access to data impede a thorough examination of labour shortages and wage increases; and given its position in the global economy, China’s economy is susceptible to international policy decisions.

Besides labour shortages and wage raises, the other sign to look for in relation to a turning point is a structural change towards a more capital- and technology-intensive industrial base. In China’s economy, three such aspects have been noticeable. First, Wu and Fan (2015, 67) find that the Chinese government promoted and heavily invested in capital-intensive and heavy industry since 2003. At the same time, the government has kept prices of fuel, water and electricity artificially low and relaxed environmental standards (Cheng and Wu 2017, 635), in order to support rapid GDP growth. In the short term, growth was indeed maintained, but in the longer term, this type of industry has led to resource depletion and environmental degradation (Wu and Fan 2015, 67) (more in the next section). Wu and Fan’s conclusions are corroborated by Garnaut and Huang (2006, 23), whose findings indicate that profit rates in sectors as petroleum and natural gas extraction and non-ferrous metals mining and processing enjoyed double digit growth since 2004. Second, Garnaut and Huang also conclude that from 2004/2005 onwards, profit margins have declined for the labour-intensive textile, garments and parts of the electronics industries, and that these have shrunk in size (Ibid.). Third,

structural change and upgrading have not been temporary phenomena. Since 2011, the tertiary sector has overtaken the industrial sector – historically the main economic sector and contributor to GDP – as largest contributor to GDP (National Bureau of Statistics of China 2018). The gap between the two sectors continues to widen: whereas in 2012, both the industrial and the services sectors contributed 45.3% to GDP, in 2017 they accounted for 40.5% and 51.6%, respectively (Ibid.).

Nevertheless, it should be noted that the industrial sector, averaging a 40% share of contribution to GDP, remains important to China's overall economic performance and growth. Compared to advanced economies, a 40% share in GDP for industry is large – in the United States for example, industry contributes 19.1% to GDP (CIA World Factbook n.d). Additionally, China remains the world leader in industrial output, mining and ore processing, metals and machine building, and continues to export mainly electrical machinery – including computers and telecommunications equipment – apparel and textiles, and furniture (CIA World Factbook 2019). Thus, while it may be concluded that structural changes are noticeable and that China has started to rebalance its growth potential toward services, these should not be overstated in the search for a turning point in economic development. Its labour-intensive industry remains important, which may actually mitigate the fears of a looming labour shortage.

IV.II Challenges: Income Inequality and Environmental Degradation

These processes of supply and demand in labour, rises in wages and living costs, and the transition from labour-intensive to capital- and technology-intensive industry have

produced two challenges that are threatening China's future economic growth: income inequality, and environmental degradation and climate change.

Since the mid-1980s, income inequality between rural and urban workers has widened (Cheng and Wu 2017, 632; Naughton 2007, 211; Ravallion and Chen 2007, 25). In general, throughout the entire reform, "Chinese society has become much better off, much less poor, but much more unequal" (Naughton 2007, 209). Indeed, as Golley and Meng were searching for evidence of the Lewis turning point in terms of rising wages, they actually found that wages of skilled urban workers increased more rapidly (more than 10% annually) than those of low-skilled migrant workers (less than 5% annually), thus widening the income gap between the two groups (2011, 558). The poor are not getting poorer, but the rich are getting richer faster (Cheng and Wu 2017, 634). Within-sector inequality has also increased, most profoundly in the urban areas. Here, incomes have risen for those possessing the skills and capital required in an economy transitioning from labour-intensive to capital-intensive to technology- and knowledge-based.

In the first phase of China's economic reform, rural poverty declined rapidly, and the rural-urban gap narrowed because of the successes of rural reform. Yet, in the second phase, alleviating poverty and narrowing the gap became more difficult: economic growth was now increasingly concentrated in the urban coastal areas because of the impact of trade and FDI (Cheng and Wu 2017, 634; Naughton 2007, 215, 219; Ravallion and Chen 2007, 29). Its benefits only reach the rural areas slowly, as China's size

and geographic diversity limit spillovers, certainly in combination with policies restricting domestic migration and the denial of certain social welfare services to migrant workers.

As with examining the extent to which labour shortages and wage rises exist in China, investigating the scope of income inequality and poverty suffers from poor data as well. As such, studies agree that analyses should go beyond looking at GDP per capita (PPP), poverty lines and the Gini coefficient to include other indicators of standards of living, such as education, life expectancy, health-related indicators, the Human Development Index (HDI), and even aspects like political status and connections (Cheng and Wu 2017; Naughton 2007; Sicular et al. 2006). However, the inclusion of more variables may assist in clarifying the size and scope of income inequality and poverty in China, but it also opens space for disagreement as to which factor contributes most to these processes, and therefore, to which factor most attention should be paid.

For Sicular et al., education has been the most substantial contributor to the income gap between rural and urban workers. They assert that if education levels in the rural areas would be increased to equal those in the urban areas, the rural-urban income gap would decline by 25-30% (2006, 31). However, Cheng and Wu advise to tread cautiously. Expanding *higher* education levels in the rural areas will likely lead to a brain drain, widening the gap between the rural and urban areas instead of narrowing it. Rather, expanding *secondary* education would narrow the gap, as it would boost labour productivity in the countryside (2017, 638). For Cheng and Wu, low productivity in agriculture is the largest contributor to income inequality. Barriers to migration 'lock in'

unnecessary labour in agriculture, rendering it unproductive, while urban labour productivity grows and the income gap widens (Ibid., 635, 646). Taking this factor as biggest contributor, a solution would be to relax domestic anti-migration policies. This would also add to minimising the fears of a tightening supply of labour (IV.I).

Ignoring the question of which factor contributes most to income inequality for now and focusing on the overall challenge it presents, the Chinese government recognises that it is a problem and has implemented initiatives to try and alleviate it[12]. An example is President Hu Jintao's "Harmonious Socialist Society"-doctrine. Social harmony has long been a central concept in CPC thought, but this specific doctrine was meant to address and tackle the negative side effects of economic growth (Kahn 2006). As such, during the 6th Plenum of the 16th CPC Central Committee, Hu Jintao identified in his speech areas such as the widening gap in income and development between urban and rural areas, education, healthcare service, environmental degradation and pollution, and corruption as problems affecting social harmony and economic growth, and asserted that more effort should be directed toward recognising and resolving these (Communist Party of China 2006; Kahn 2006). Similarly, a key objective of the 13th Five-Year Plan (2016-2020) is to move toward a path of more balanced, sustainable and inclusive growth (OECD 2016, 1). This is important, because, as Naughton puts it, "a more inclusive growth

[12] To be sure, scholars still debate whether income inequality has a positive or negative effect on economic growth and have found that both cases are possible. While the debate remains inconclusive, there appears to be agreement that high income inequality retards economic growth in high- and middle-income countries and reduces human capital (educational attainment) and upward social mobility. Although this conclusion is simplified, it fits China's current economic challenges and opportunities, and therefore, this research follows the conclusion that income inequality negatively affects economic growth. See for example Cingano (2014) and Lederman (2015).

model will spread the ultimate benefits of growth more broadly among the population, but a healthier, better fed, better educated population will sustain better the next phase of economic growth" (Naughton 2007, 227).

The final challenge to economic growth that this thesis will discuss, is the issue of environmental degradation and climate change. Since the reform, both economic and population growth have put severe strains on the environment. The biggest problems China is currently facing can be classified in two groups: air and water pollution, contributing to poor air quality, acid rains, and poor water quality and shortages; and an unsustainable demand for and use of natural resources, contributing to the emission of greenhouse gasses, soil erosion and degradation, biodiversity loss, and losses of forests, grasslands, and crop lands (Liu and Diamond 2005, 1179; Naughton 2007, 489).

As the world leader in industrial output, which was given extra impetus in the early 2000s, China mainly exports primary and manufactured goods but consumes the resources necessary for their production, leaving behind the pollutants (Liu and Diamond 2005, 1179). China is one of the largest consumers of energy worldwide, leading in coal production and consumption, ranking second in petroleum imports and third in natural gas imports globally (IEA 2017). Roughly from 2005 onwards, China started to produce more coal than all OECD countries combined, culminating to China's share in total global coal production climbing to 44,5% (Ibid., 16-17, 31). This extensive use and extraction of non-renewable resources has rapidly increased China's emission of greenhouse gasses, especially carbon dioxide (CO_2). To put this into perspective: from 2005 onwards, China

became the largest CO_2 emitter worldwide; and in 2015, it emitted more CO_2 than the EU28 and the United States combined (10,6 kilo tonnes versus 8,6 kilo tonnes) (EDGAR 2016). Furthermore, given its population growth and increasing wealth since the reform, more stress is put on agricultural production and consumption; and its infrastructure and transportation network and demand for trucks and cars have grown rapidly (Liu and Diamond 2005, 1179-1180; Naughton 2007, 489-490).

These environmental problems produce enormous economic and social costs in China. Already in 1997, the World Bank estimated that total air and water pollution costs amounted to at least US$54 billion per year, equal to, at that point, 8% of its GDP (World Bank 1997, 2). According to Naughton, total health and productivity losses because of illness – particularly bronchitis, as a result of pollution – amount to more than US$20 billion per year (2007, 494). A "less significant number", but still indicative of the seriousness of China's environmental problems, is the US$250 million lost because of factory closures in one city (Xian), a result of water shortages (Liu and Diamond 2005, 1183).

It is evident from the increase in non-renewable resource use and greenhouse gas emissions in the first decade of the 21st century that China has prioritised economic growth before environmental protection. Environmental degradation and resource depletion may now put considerable strains on further industrial growth, as the example of Xian demonstrates. With a strong dependency on its apparel and textiles industry, which are water-intensive industries, large-scale factory closures could impose

considerable costs. However, China is also trying to improve its practices. Roughly since 2010, China is substantially increasing its efforts to generate energy from renewable sources. It is even, by far, the largest producer of renewable electricity globally. When looking at hydroelectricity, wind electricity, and solar power, China accounts for 28,4%; 22,2%; and 18,3% of total global production, respectively. In its total domestic electricity generation, 19,3% came from hydroelectricity; 3,2% from wind electricity; and 0,8% from solar power. As such, with 23,3% of its total domestic electricity deriving from renewable sources, China is doing better than the United States (11,5%) and beats the global averages (IEA 2017, 20-25, 31).

In the longer run, since the beginning of the reform, the Chinese government has paid attention to environmental conditions and has assumed responsibilities to mitigate their consequences. For example, in 1983, environmental protection was declared a basic national policy; and in 1988, the National Environmental Protection Agency was established, which became the State Environmental Protection Administration in 1998 (Liu and Diamond 2005, 1181; World Bank 1997, 7). Additionally, China has signed on to several international climate change treaties, with the most recent being the Paris agreement – in contrast to the United States, which is still the second largest emitter of CO_2 (EDGAR 2016) – and participates in the UN Sustainable Development Goals. Its national action plan for implementing the UN 2030 Agenda for Sustainable Development focuses particularly on energy, pollution, education, poverty, and health (Paul 2016; State Council of the PRC 2016). Economic growth has long been prioritised, but the Chinese government can no longer ignore the environmental challenges it is facing.

In sum, income inequality and environmental problems both present severe challenges to China's future economic growth. Environmental degradation and resource depletion may harm further industrial growth. The effect of the income gap on the educational levels of the rural population may hinder a further transition to a more technology- and knowledge-based economy. Although they represent different consequences, both challenges need to be tackled in order to safeguard future economic growth. The government has recognised both income inequality and environmental degradation as severe challenges to its economic growth; yet, launching a new doctrine or participating in international initiatives look good on paper, but results are not achieved overnight, especially not in such a large and diverse country. However, opportunities do exist to mitigate the impacts of income inequality and environmental degradation on future economic growth.

IV.III Opportunities: Will Economic Growth Persist?

How long will China's growth continue? Are labour shortages, income inequality and environmental degradation challenging enough to halt the progress China has made over 40 years? In relation to these questions, several scholars and institutions have identified issues that require further reform in the 21st century for growth to be sustained. Naughton (2007, 107-108) asserts that opportunities for further reform in the 21st century lie with reducing the hold of the government, especially over the banking sector and the financial system; and improving the business environment, particularly corporate governance, transparency, regulation, and legal rights and fairness. Garnaut (2006, 4)

agrees with Naughton that the “most important barriers to continued strong growth” are weaknesses in China’s financial institutions and the strong governmental hold over the state sector. This can also be found in the OECD’s recommendation for safeguarding future growth, especially as China transitions to a knowledge-based economy. Besides increasing its efforts in financial markets and the business environment, more work remains to be done for the Chinese government in the innovation framework, education and skills, and digital infrastructure (OECD 2016). The importance of education and skills has also been acknowledged by McKinsey&Company, in relation to looming talent shortages and pressure on competitiveness as China transitions towards a services-based economy (Farrell and Grant 2005).

Of course, given the size and diversity of China’s economy, more opportunities exist. For instance, in 2015, the Financial Times reported on large capital flows out of China as a result of concerns over the stability of the renminbi and arbitrary governmental anti-corruption crackdowns (Donnan 2016). In light of the trade war with the United States, fears of another flight of wealth have returned (Karnfelt 2018). Bloomberg identifies the lack of freedom and the intrusiveness of the surveillance state as key in the outflow of Chinese university students and young talent (Smith 2018). Recently, the United States and several European countries have become concerned with the trustworthiness of Chinese companies, especially in terms of stealing of and spying on technology, data and intellectual property, as the Huawei scandal indicates. However, these opportunities still depend on further reform of the power of the government over

its SOEs and financial system and on improvements in the business environment. When these are addressed, it is likely that other opportunities will be positively affected as well.

Interestingly then, the opportunities for future growth lie in aspects that have been central to the reform strategy. The fact that these are now discussed in terms of barriers to sustained economic growth may indicate that they have been insufficiently addressed by or changed during the reform. Why do these three areas need more reform? How can their change advance economic growth? Essentially, the entire reform strategy and procedure explains this: less governmental interference and control will lead to more competition and more space for entrepreneurialism and innovation, which will produce better economic incentives and enable further diversification and upgrading of the economy. China has made substantial effort to realise this diversification and upgrading, as 40 years of reform have shown, but is not yet where it wants or needs to be.

In the course of economic history and development, every economy shifts from agriculture to labour-intensive manufacturing to higher values areas, and ultimately, services are the engine of sustained growth (Farrell and Grant 2005, 11). The World Economic Forum also acknowledges that China's long-term economic outlook lies in the services sector: it is consumer-oriented – a huge potential for future economic growth, as China's domestic demand and consumption has generally been weak (Garnaut 2006, 5; Garnaut and Huang 2005, 12, 15; Wu and Fan 2015, 66) – and it is labour-intensive, and therefore capable of relieving pressures on China's industrial and manufacturing sectors

(Roach 2015). One of these pressures is employment. As in the second phase of reform, when millions of jobs were shed because of SOE reform, it is likely that this will occur again – either by state-sector restructuring or the transforming to a services-based economy, or both. Additionally, the United States has recently shown that it can inflict pressure on China's economy by targeting its exports. The trade war, in the form of import restrictions on Chinese goods, have shown that this is where the Chinese economy can run into trouble: its industrial and manufacturing sector. Upgrading towards a more service-, knowledge- and technological-based economy could therefore alleviate these pressures on employment and exports. An additional benefit is that it would put less stress on the environment.

The 'Made in China 2025' strategic plan exemplifies this upgrading from industry and manufacturing to higher value products and services. With Made in China 2025, implemented in 2015, Premier Li Keqiang and the CPC intend for China's economy to transition away from its reputation as 'workshop of the world' toward global leadership in knowledge-intensive manufacturing. The digital economy, Internet of Things, IT, and automation are key aspects in achieving strategic goals such as improving the quality of products made, creating own brands, researching new materials and resources, and producing key components of technologically advanced products (Li 2018, 67; State Council of the PRC 2017). E-commerce (Alibaba) is a fitting example of a growing digital economy, improving services and boosting consumer spending. Other areas in which China is already excelling are aerospace equipment, infrastructure and transportation networks, and supercomputers. The next step would be to move from internationally

recognised industries, to internationally recognised brands (Li 2018, 68). In this, Alibaba is a start. As such, Made in China 2025 is used as a new industrial revolution to create efficiencies, improve services, create more jobs, and contribute to economic growth. In fact, Made in China 2025 might be the third phase of economic reform.

In this transition, what needs to be improved? The government's hold on the financial sector and SOEs refrains China from achieving a full transition to this digital, knowledge-intensive economy, as it distorts the attractiveness of the business environment for (foreign) private firms and innovative startups. The financial sector, for example, remains dominated by state-owned banks, which are subjected to political incentives and decisions. This makes it more difficult for startups to access credit, as they have limited funds and no proven track record (OECD 2016, 5). Granting private banks access to the sector will stimulate competition and non-politicised funding, and allowing for the development of non-bank sources will facilitate corporate funding for younger and smaller firms. Further reform of the state-owned sector will also contribute to financial reform. SOEs in protected sectors (telecommunications, for example) are privileged by the government when it comes to investment and funding, but this distorts the market's ability to efficiently allocate capital and determine interest rates (Dorn 2013). In continuing its practice of rescuing failing enterprises, the state contributes to trapping valuable resources in non-viable enterprises or sectors, thereby inhibiting creative destruction (OECD 2016, 5). As in the second phase of reform, the state must allow for further downsizing and privatisation in order to achieve economic upgrading.

Additionally, the business environment needs to be made more attractive to and supportive of entrepreneurship and innovation. Foreign investment is directed into certain sectors while market access to others, especially the service sector, is limited. Investment here is subjected to screenings and approvals, and often, special licenses or public-private partnerships are required to gain access (Ibid., 7). According to the latest World Bank *Doing Business* report, China should direct more effort to facilitating access to credit, enforcing contracts, and resolving insolvency. Still, of the 190 countries examined, China has made the third-most progress in facilitating new business, inciting changes in 7 out of the 10 indicators of the ease of doing business (World Bank 2019, 11). In the context of transitioning to a knowledge-based economy that runs on innovation and technology, improving the regulatory framework and making it more transparent – especially the protection of intellectual property rights (IPR) – is imperative, as American and European concerns and actions against Huawei indicate.

China's economic growth has been spectacular, and unmatched by any developed or developing country. Yet, since the beginning of the 21st century, challenges in the form of income inequality and environmental degradation and climate change have started to threaten this growth, and labour shortages and rising wages are looming as a serious consequence. However, numerous opportunities exist to mitigate these and fuel further growth. These are mostly founded upon further reform of the financial system, reducing the hold of the government over SOEs, and improving the regulatory framework, fairness and transparency of the business environment. If substantial results are achieved in these areas, China can act on changing its economic structure toward a knowledge-based and

technology-intensive economy more rapidly. With a more transparent and fair business environment, China becomes more attractive to foreign firms, expats and its own young talents, retaining valuable knowledge within its economy and providing better incentives for employment. In this process, it must be ensured that these benefits are spread more equally across the population. Improving education is the first step. While Made in China 2025 present opportunities to relieve income inequality, it may also worsen it if not implemented cautiously as it requires educational reform. Additionally, a different economic structure, new technologies and a more knowledgeable population will likely relieve stress on the environment.

However, continued economic growth is no longer solely a domestic question, as this chapter has also demonstrated. Given the importance of China's economy for the global economy, its economy and domestic policies are increasingly placed and judged in an international context. The United States has shown that it can hurt China's export-based economy. Together with the European Union, concerns have been voiced about the involvement of China's government in enterprises, and actions to block Chinese access to their domestic markets have been undertaken – all indicative of a continuing trust problem in business relationships. Additionally, China's population is increasingly negatively affected by its economic growth – in terms of income inequality and the consequences of climate change – and are becoming more outspoken about their expectations. As such, the opportunities to advance economic growth span international and domestic political, societal, and economic dimensions. Therefore, further growth depends on a combination of the international perception of China's economy, and

domestic acceptance of the goals China wants its economy to achieve and the strategy it pursues in this.

CONCLUSION

This thesis aimed to provide an historical assessment of China's economic reform and a contemporary perspective on the sustainability of China's economic growth. In this process, two questions have been examined: to what extent has China's economy been reformed – to what extent has it been liberalised, and to what extent has it been kept under control, since economic reforms were initiated in early 1979?; and will China be able to continue its economic growth, or not? The first question has been the focus of this study, while the second question has been used as a framework and debate to place the analysis of the reform procedure into.

Since early 1979, the People's Republic of China initiated economic reforms. The entire reform strategy and procedure revolved around a balancing act between control and liberalisation. From the beginning of the reform up until today, China has mixed economic systems. The government decides which sectors or enterprises are key in its national and international ambitions, such as the financial and telecommunications sectors, controls these and restricts foreign investment and access to them. Others, like textiles and electrical machinery, have been opened to the market and have become important parts in global value chains. China's rapid economic growth indicates that it has made substantial effort in becoming an open, liberalised, market-based economy, but a closer look at the institutions governing its economy indicate that the reform has not been completed. Governmental control over selected enterprises and sectors is the issue most in need of further reform.

The durability and sustainability of China's economic growth now depends on the government's ability to address the aspects that been insufficiently changed during the reform: the Chinese government's hold over SOEs, its control over the financial system, and the fairness and transparency of the business environment. Further reform of these will facilitate the transition to a technology- and knowledge-based economy, the government's new strategic goal. However, transitioning to such an economy requires entrepreneurialism and innovation, sustained by a well-educated population. The controls of the government on SOEs and certain sectors not only inhibits the development of a business environment necessary for economic upgrading, but also inhibits the solving of three challenges threatening continued economic growth: the possibility of labour shortages, the gap in income inequality between the urban and rural areas, and the costs of environmental degradation and climate change. Restrictions for private firms and startups prevent them from creating additional labour. The income gap negatively impacts the attainment of the educational levels needed for this type of economy, especially for the rural population. Environmental degradation and resource depletion may harm further industrial growth, which China's economy still greatly depends on.

Advancing economic growth, then, will depend on China's ability to further reform three areas that have been insufficiently reformed during the last 40 years: the Chinese government's control over SOEs, its hold over the financial sector, and the business environment and regulatory framework. Improvements in these areas will likely produce ripple effects on other opportunities for continued growth. However, as such

economic policy changes span international and domestic political, societal, and economic dimensions, their realisation might prove difficult. Further research into the linkages between the consequences, challenges and opportunities China's economy is currently facing could be fruitful, especially when connected to domestic needs or international concerns.

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