**Learning by Debating:**

**The Changing Role of the State**

**in China's Economy and Economics Theories**

Policy Studies Journal, Vol. 23, No. 1 (Spring 1995), pp. 11-25

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November 12, 1994

An attempt to reform the classic centrally planned system, in essence, is an attempt to change the role of the state in the economy. Characterized by state monopolization, omnipresent regulation, and centralization, the old system was a command economy (Wang, forthcoming). Reform thus has to start with reducing the scope of state intervention. Given the deep-seated ideological hostility to the market that prevailed in the pre-reform era, the substitution of market coordination for bureaucratic coordination would never be an easy task. It would take a long time for the people as well as policy-makers of a state socialist country truly to appreciate the virtues of the market.

However, they may go overboard, stressing the advantages of the market in stimulating flexibility, innovation, and efficiency without realizing its deficiencies. Disillusioned with central planning, they may uncritically embrace the currently fashionable neo-classic economic doctrine and join its aficionados in calling for unqualified "state-shrinking." Perhaps a consensus may never be reached on the question of "how much and what kind of state intervention is necessary for the proper function of market." Nevertheless, a nation in transition would sooner or later realize that it is dangerous to run to either extreme.

The search of the ideal range of state intervention is a learning process. The reform leadership may learn how to redefine the scope of state intervention from the negative and positive experiences of its own nation, other socialist countries, and mature market economies. They may also learn through trial and error during the course of market transition. Lessons drawn from the past, from others, and from current practice, however, cannot speak for themselves. Rather, they are always subject to dispute. Debate thus is unavoidable.

This essay deals with such debate in China. Indeed, as a number of studies have shown, every step of reform in China was accompanied with some furious debates and the key point in all those debates has centered on the relationship between the state and market (Chen, 1990; Hsu, 1991; Hua, Zhang, & Luo, 1993; Fewsmith, 1994). Where did the debates fit into the policy process?

Economists were most active in engaging themselves into such debates, but few took part in them purely for academic reasons. Many participants of the debates held positions on advisory bodies located directly under certain decision-making organs, and some had respect and trust of top leaders. Even those who had no personal connections with political leaders hoped somehow to influence policy-making. Whatever their backgrounds, those economists were policy advocates when they were involved in such debates. The name of the game they played was "competitive persuasion:" each side attempting to formulate persuasive arguments about appropriate course of future reform, in competition with other sides offering alternative advices (Halpern, 1992). Different schools of thought emerged from those debates did not exist independently of the political process. Political leaders who had conflicting visions of reform needed economists to provide rationales for their own policy preferences and to refute their adversaries'. And, whichever faction prevailed in politics, it needed economists' help in selling its program to policy implementors and the public. Therefore, top leaders often incited their favorite economists to fight in a debate on their behalf. Economic debates thus were inextricably intertwined with the struggle for power.

However, those debates were not completely manipulated by political leaders. While the political process set the framework in which economic issues were debated, debate participants had the desire and ability to push the parameters of the debates in directions that were different from what political leaders had chosen, and thus to affect the policy-making process according to their own reform agendas (Fewsmith, 1994). As policy advocates, economists possessed some propensities that policy makers generally lacked. First of all, political leaders had to count on economists theoretical proficiency to conceptualize reform and clarify its goals. By interpreting economic changes and offering broad cognitive maps of transition for the leadership, the economists were in a unique position to influence the way in which central leaders thought about reform. Moreover, their historic and comparative perspectives enabled them to float "fresh" ideas and introduce "new" ways of thinking for policy-makers, which could significantly expand the range of policy options. Finally, political leaders had to rely upon economists' technical training and relatively long term horizon to assess the likely consequences of various policy options and thus eliminate certain harmful alternatives from further consideration. Although policy-makers rarely accepted particular proposal put forward by any individual or group, debates among economists did exert imperceptible yet substantial influence on policy process in some long-range fashion.[1]

This essay traces the main lines of debate over the state-market relations in China since the inauguration of reform in 1978. The next section examines how the market has become gradually legitimated in the socialist country. The following section focuses on Chinese economists' current debate on how to redefine the economic role of the state. The discussion shows that the debate has radically changed the conceptual frameworks of Chinese economists and policy-makers, which is likely to circumscribe what I call China's "zone of future reform."

## The Legitimatization of the Market (1979-1991)

China's economic reform since 1978 has long been called a "market-oriented reform" by outside observers, but the Chinese government didn't formally accept the conception until late 1992. In other words, it took China 14 years finally to get rid of the dogmatical interpretation of socialism. The concept of "market" had been treated as "the embodiment of capitalism and the antithesis of socialism" in the pre-reform China all along (Hsu, 1991). It therefore was not surprising that such an attitudinal change took so long. The legitimatization of the market went through several stages.

When China's reform began in 1978, even the most radical reform-minded economists believed that the purpose of reform was to improve the centrally planned system rather than to replace it with something else. Nevertheless, the past experience with central planning had demonstrated that "when you try to plan everything, you plan nothing." Thus, increased voluntary transactions among economic agents were regarded as an antidote to the rigidities and excesses of Soviet-styled planning. To provide a theoretic or ideological basis for this pragmatic need, some Chinese economists began to argue, by reinterpreting key Marxian economic categories (commodity, value, price, etc.), that the market was not incompatible with socialism. By the early 1980s, this view had become widely accepted (Lin, 1989).

At that time, however, most economists still didn't have much faith in the market. In their view, the utilization of the market was a temporary concession only to be justified by the immaturity of the socio-economic conditions for real socialism. And they believed that the restricted use of the market mechanism was sufficient for eliminating planners' imperfections. That explains why the prevailing policy slogan in the early 1980s was "central planning is primary, market mechanism supplementary." It then was widely held that the combination of the plan with the market could bring about "the best of both worlds," and that what was crucial to China's reform was to find the optimal boundary line between the planning and the market. Many suggestions were made. Some economists maintained that current production should be regulated by the market, and investment by the planner (Hua, Zhang, & Luo, 1993). Others contended that the state sector should be subject to state planning, and the non-state sector left for the market. Still others insisted that key products (like coal, steel, and machine building) that were vital to the economy should be kept under state control, and most consumer goods and some producer goods freed from state control. Most held that product markets should be open, while factor markets should be barred (Hsu, 1991).

The search for the optimal separation line between the planning and the market turned out to be much harder than initially expected. As the reform proceeded, it became increasingly evident that none of suggestions mentioned above was viable. To increase efficiency and economic output, reformers found it imperative successively to enlarge the role of the market and further weaken state intervention. In 1984, the Party put forward a new reform guideline--"socialist planned commodity economy"--to replace the old one--"central planning is primary, market mechanism supplementary." Moreover, the Party's Thirteenth Congress of 1987 defined the "socialist planned commodity economy" as an economy in which "the state regulates the market, and the market guides firms." Unlike the old model in which the market was supposed to be dominated by the state, the new model seemed to suggest that the market should become the center of gravity in the economy, though it still needed to be balanced by the plan.

However, "socialist planned commodity economy" was a rather equivocal formula, which caused a great deal of confusion. Arguing that there could be no production and exchanges of commodities in the absence of markets, some economists asserted that the commodity economy in essence was a market economy. But others disagreed. They insisted that planning should be the main attribute of a socialist economy even if it legitimated commodity exchanges. The former group advocated that the concept of the market should be expanded to include producer goods market, technology market, capital market, and labor market, whereas the latter group was only willing to allow minor products to be regulated by the market (Wu, 1993).

The first group prevailed from 1984 to 1988. Economic policies of Zhao Ziyang, then the Prime Minister and Party General Secretary, were heavily colored by the thoughts of this school (Hua, Zhang, & Luo, 1993). After the Tiananmen of 1989, however, Zhao was dismissed from his post, and the second group gained the upper hand. A return to an all-embracing command economy was not what the group desired. But those theorists didn't trust the market. Blaming "excessive marketization" for having created the "neither market nor plan" chaos witnessed in the late 1980s, they called for a measured reinstatement of the role of state planning in the economy (Liu, 1991; Wei, & Huang, 1992; Ning, 1992; Luo, 1992).

The conservative current did not last long. During his tour of South China in the spring of 1992, Deng Xiaoping made a comment on the plan-market controversy: "Planned economy is not tantamount to socialism, as capitalism also has planning; and the market economy is not tantamount to capitalism, as there are markets in socialism, too" (Wu, 1993). Due to Deng's personal intervention in the debate, the anti-market backlash that had emerged after 1989 faded away in no time. No longer was there anyone who dared openly to argue that "the market economy is a patent of capitalism." In October 1992, the Party declared at its 14th national congress, for the first time, the establishment of a "socialist market economic system" as the object model of the country's reform. In March 1993, China even amended its Constitution to accommodate to the conceptual change. For a country where not long ago even minor market exchanges were condemned as the "tails of capitalism," such a conceptual change is by no means trivial. Rather, it signals that China is entering a new age, an age in which the market needs no more justification.

The official sanction of "socialist market economy" conveys the following important messages: 1) The object model of reform is no longer an improved planned system but a full-fledged market system. 2) The market, rather than the plan, should become the principal mechanism of resource allocation. 3) Product markets should be further perfected and factor markets liberalized. 4) The domestic market should be connected with the international market. 5) The government should leave to the market what can be best handled by the market and only concern itself with what the market cannot accomplish. 6) The government should use economic levers rather than administrative orders to steer the economy. 7) Existing socioeconomic institutions should be remoulded and new institutions established to facilitate the proper function of the market. In sum, the concept of market has by now become fully legitimized in China.

**Table 1: Changes in China's Pricing System**

| | 1978 | 1985 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|---|---|
| Overall Retail Sales | | | | | | | | |
| Planned Price | 97.0 | 47.0 | 31.3 | 29.8 | 20.9 | 10.0 | 5.0 | 5.9 |
| Negotiated Price | - | 19.0 | 23.2 | 17.2 | 10.3 | | | |
| Market Price | 3.0 | 34.0 | 45.5 | 53.0 | 68.8 | | | |
| Sales of Agricultural Products | | | | | | | | |
| Planned Price | 92.6 | 37.0 | 35.3 | 25.0 | 22.2 | 15.0 | 10.0 | |
| Negotiated Price | 1.8 | 23.0 | 24.3 | 23.4 | 20.0 | | | |
| Market Price | 5.6 | 40.0 | 40.4 | 51.6 | 57.8 | | | |
| Sales of Producer Goods | | | | | | | | |
| Planned Price | 100 | - | - | 44.6 | 36.0 | 30.0 | 15.0 | |
| Negotiated Price | - | - | - | 19.0 | 18.3 | | | |
| Market Price | - | - | - | 36.4 | 45.7 | | | |

Sources: Zhang, 1992; National Price Bureau, 1992; Chen, 1993; People's Daily, October 27, 1994.

The gradual legitimatization of the market has profoundly changed the mode of resource allocation in China (Ma & Lu, 1994). Before the reform, the country had a highly-centralized system of resource allocation, under which the allocation and pricing of almost all consumer goods and production factors were determined by the government. Since 1979, China has perceptibly reduced the scope of the mandatory plan and expanded the scope of market allocation. While the government set production targets for over 95% of industrial products in 1979, the figure has dropped to about 5% today (People's Daily, October 27, 1994). In 1980, the government directly controlled the allocation of 837 categories of production materials, but it controls only 11 now (People's Daily, November 20, 1993). Meanwhile, the government has lifted most price controls. As Table 1 indicates, the share of planned price has steadily declined in all categories of sales. By 1994, the planned price only applied to about 5% of the nation's overall retail sales, 10% of the sales of agricultural products, and 15% of the sales of producer goods. It is conceivable that China's product market will soon become completely free. Markets for technology, capital goods, labor, and even property rights have also been rapidly developing in the last several years. Seen in this light, no one can deny that China has traveled a great distance in its economic reform since 1978. Although many still hesitate to call China a market economy, at least some observers believe that "China already becomes an essentially market economy" (Chow, 1993). Most probably prefer terms like "mixed system" (Dernberger, 1992) or "hybrid system" (Shan, 1992). No matter what terms are chosen to describe China's economic system, one thing is indisputable: it is not a centrally planned economy any more.

## The Legitimatization of the Role of the State (1992-?)

After "socialist market economy" was declared to be the ideal, the discourse has changed in discussing the relations between the state and the market. What now needs to be justified is no longer the market but government intervention. In the 1980s, reform-minded economists concerned themselves so much with how to legitimize the market that their attention was focused on restricting political and administrative interference in the operation of the economy. Although they generally admitted that the state should have a role in the economy, few gave serious thought to specifying the areas in which the state ought to play an active part. In other words, there were only nebulous arguments for "more" or "less" state intervention but no theories.

After the official sanction of "socialist market economy," the attention has shifted to defining the appropriate role of the state. Most Chinese economists now agree that the state should let markets work where they can, and step in only where they cannot (Gao, 1993). Beyond this general principle, however, their views are very divergent. What problems can be resolved by the market? What problems cannot be resolved by the market? Should the government intervene where the market fails? What are the most efficient instruments for the government to conduct its interventions? Those are among the questions that Chinese economists and policy-makers have been debating. The problem is that most Chinese academics' exploration on this subject has just begun. Therefore, their arguments are still relatively rudimental, and only a very small number of them have advanced some systematic thoughts. For the sake of discussion, I categorize views expressed in the debate according to the range or areas of state intervention various authors would prefer to see. Broadly speaking, three schools of thought can be identified.

**Market Failure School**

"Market failure" is a rather new concept in China. It is only in the last few years that the concept has begun to gain currency on leading economics journals. Many Chinese economists have found the concept appealing and useful in justifying state restriction of market competition. They form a loosely defined school of thought. The school, as its name indicates, relies on the theory of market failure elaborated in Western welfare economics to determine where government intervention is appropriate. Presumably, a functioning market is generally able to provide for the efficient allocation of goods and services. However, markets may fail to achieve socially desirable outcomes in some areas for one reason or another. Those perceived ills of market solutions cannot be adequately addressed by voluntary collective actions. Therefore, the state should step in where markets fail.

This school of economists often cite instances of market failure from standard Western economics textbooks to identify the areas in which they believe the government shall intervene (Zhang, 1992; Wu, 1993; Song & Zhang, 1993).

Public goods Included here are such items as national defense, roads and bridges, pollution control, etc. Characterized by their broad use, indivisibility, and nonexcludability, "public goods" cannot be provided for through the market system, i.e., by transactions between individual consumers and producers.

Macroeconomic stabilization is considered a "public good." Market economies have been characterized by fluctuations in the business cycle, by periods of boom and bust. Although all economic agents would benefit from macroeconomic stability, few are willing to make contribution to its realization. Therefore the government has to use various policy instruments to manage the level of aggregate demand in hopes of maintaining high employment, a reasonable degree of price stability, soundness of foreign accounts, and sustainable economic growth.

<u>Externalities</u>  Wherever externalities exist, the actions of an economic agent (individual or firm) impose costs upon or provide benefits to third parties who are unlikely to receive compensation or to be charged through markets for what they get involuntarily.

<u>Increasing Returns</u>  Where economic activities are subject to increasing returns (and/or decreasing marginal costs), a free market will result in monopoly.  Facing no competition, a profit maximizing monopolist tends to sell a lower output and charge a higher price than would pertain under perfect competition.

<u>Incomplete Markets and Incomplete Information</u>  The former refers to situations in which goods and services are not provided because information about them is unattainable.  Future market is an example.  The latter refers to asymmetric distribution of information between agents involving in economic transactions.

Moreover, even if a competitive market might generate a Pareto-efficient allocation of resources, the resulting distribution of resources (welfare) needs not be socially just.  According to the second theorem of welfare economics, for any Pareto-efficient allocation, there exist a set of prices that support that allocation as a market equilibrium, but each with a different distribution of welfare.  The problem is to decide which Pareto-efficient allocation conforms to the society's notion of distributive justice. Obviously, the market cannot do it.  The social welfare function is simply not a market construct; it must evolve from the political process.

In sum, the rule of thumb for the market failure school is pretty simple:  Markets should be given as much leeway as possible to function efficiently, free from undue interference.  However, when they fail to provide socially desirable goods and services at optimal levels, or when they malfunction, producing socially undesirable results, the government should take action to correct such market failures.

**Neo-classical School**

Since the mid-1980s, hundreds of Western economics books have been translated into Chinese, among which probably most can be safely categorized as belonging to the neo-classic school of the West.  As a result, some Chinese economists, especially younger ones, have become ardent disciples of the Western neo-classic school.

Just like their counterparts in the West, the Chinese neo-classical economists' catch word is efficiency. They tend to have a much stronger faith in the efficacy of the market than do the economists of the market failure school. In their view, if the government leaves the private sector alone, unfettered competitive markets would generate efficiency. The state in this theory is a source of unwanted interference that may create deviations from perfect competition. Its role thus should be restricted to maintaining order and setting the "rules of the game" in the economy (e.g., providing defense, defining property rights, enacting and implementing a system of laws, and enforcing contracts). "Night watchman" is an analogy the neo-classic economists often use to describe their ideal type of government (Sheng, 1992; Jiang, 1993a).

The neo-classic economists do not deny that the market may fail, but they contend that market failure is not necessarily an argument for government intervention. Their reason is that the government could fail, too. They can point out many instances of colossal government failure in China's recent past. In their judgment, government failure is generally far worse than market failure. Comparing to government failure, market failure thus is a less evil (Jiang, 1993b).

"Public choice" theory of the state strikes a strong chord in those economists. Pervasive corruption in the Chinese society has led them to believe that incumbents in public office, like all other social actors, are just rational maximizers. In their writings, therefore, the communist government is no longer portrayed as a benevolent social guardian. Rather, it consists of a multitude of actors: politicians, bureaucrats, technocrats, and so on, all of whom are as concerned with their self-interest as those in the private sector. Although there are selfless politicians and civil servants who care about the public good, most of government officials are primarily concerned with survival, promotion, and other rewards. Moreover, they tend to use the authority of government to distort economic transactions for their personal benefit whenever chances arise (Jiang, 1993b; Yang, 1994; Zhang, 1994). From this model of government motivations, the Chinese neo-classic economists conclude that intervention with the market by the largely predatory state is bound to make matters worse. Government action is not the solution;

it is the problem. Therefore, state intervention ought to be reduced to a minimum.

**Structuralist School**

By the structuralist school I refer to those economists who refuse to accept any given relations between market and state control as ideal or optimum. The diversity of opinion exists among those economists, but they all share a strong belief that the range of state intervention should vary according to the moment and the situation.

Like the market failure school, the structuralist school has a profound doubt about the neo-classic assumption that whenever there is disequilibrium in the sense of a demand and supply imbalance, it can get corrected by the self-correcting mechanism inherent in the market system. It also concurs in the market failure school's two premises: Markets may fail in some circumstances, and market failures should be corrected through appropriate state interventions. By twisting the neo-classic economists' logic, the structuralists argue that government failure is not necessarily an argument for unfettered markets either.

However, the structuralist school differs from the market failure school on two points. First, while the market failure literature characterizes market failures as exceptions to the general rule that decentralized markets lead to efficient allocation, the structuralists tend to accept the findings of some more recent studies that reverse the presumption: It is only under exceptional circumstances that markets are efficient (Greenwald, & Stiglitz, 1986). If markets are never constrained Pareto efficient and market failures are pervasive (Stiglitz, 1991), then there is little point to identify market failures. Although the pervasiveness of market failures doesn't warrant the state in thrusting its nose into everything, the "optimal" range of government interventions is nevertheless much larger than the market failure school recognizes.

Second, the standard market failure arguments assume that market economies are all the same, and thereby there exists a common model of state intervention that can solve market failure problems for all countries, at all times. This is apparently a false assumption. Take Japan and the United States, two highly developed market economies, as examples. The two countries differ significantly in their perceptions of what constitute "market failures" and what steps should be taken to deal with such failures. The United States prefers to leave the market alone unless there is tangible evidence of a breakdown. Japan, by contrast, is skeptical that a strictly hand-off posture will yield outcomes that coincide with sectoral priorities, public interests, and national goals. Hence, the visible hand of the state has worked in conjunction with the invisible hand of the market in Japan much more than in the United States. Moreover, as the time goes by, the range of state intervention in Japan has changed considerably (Okimoto, 1989).

From the viewpoint of the structuralist, the contrast between the United States and Japan and the changing boundary between the state and the market in Japan itself cannot be explained by purely perceptional differences. Rather, they indicate that the market may fail in different ways with respect to goals that a nation is pursuing, level of development, geographical location, international economic and political environment, size of country, culture, and many other factors. If this is true, a theoretically optimal boundary between the market and the state can never be found. Different countries may have to deal with different kinds, and different degrees, of market failure, which requires them to devise different institutions to overcome such market failures.

The structuralists believe that the necessary level and desirable form of state intervention should vary according to circumstances. For this reason, they emphasize the distinctive features of China and its market transition, and try to specify the role of the state in this context (Chen, 1992; Guo, 1992; Wu, & Ling, 1992; Gu, 1993; Wei & Zhang, 1993; Liu, 1994; Wang, 1994a). So far, the most systematic expression of the Chinese structuralist school can be found in Wang and Hu (1993). Their arguments are based on the following three observations.

<u>China is a developing country</u>. According to the neoclassic economic theory, the market is good at achieving Pareto efficiency. But the notion of Pareto efficiency is essentially a static one, which concerns only about the allocative efficiency of given resources. From the standpoint of underdeveloped countries, dynamic value creation is far more important than static value allocation. However, long-run development involves many "big" industrial decisions that cannot automatically flow from decentralized, optimal decision making in the short run. Even in developed economies, the structure and level of long-term, large-scale investments (including R&D,

education, job training) are not entirely guided by the market, for two good reasons. First, the markets that are necessary for such investments to be efficiently allocated, namely future markets and risk markets, are far from complete, if they exist at all. Second, such investments tend to generate positive externalities so that even were future and risk markets to exist, market-determined investments would be socially suboptimal.

Typically, in the initial stage of economic development, sources of capital are scarce and diffused, and private entrepreneurs with the will and capacity to invest are few and far between. However, countries that prepare economic take-off have to build up a solid infrastructure and alleviate structural bottlenecks, both of which by definition involve big investments, externality-intensive type of investments. Direct state investment is necessary during this phase of industrialization, because only the state has the ability to extract required capital from the society through forced saving. In Britain and France, two early developers, for instance, the state played an important role in supporting the process of primitive accumulation in the first stage of capitalism--the mercantilist period. State and local governments of the United States also made sizable direct investments in infrastructure projects in the early economic development (Goodrich 1968).

For later developers, things are more complicated. To jump into the modern industrial sectors, they often confront production technologies with capital requirements in excess of what individual investors are capable of amassing. Gerschenkron has established that the later the industrialization takes place in relation to the first industrial countries, the more directly the government tend to become involved with the extraction and allocation of resources (1962). Germany and Japan at the end of last century and Korea and Taiwan in the recent past are the well-known cases of successful state-led industrialization.

A developing country needs not only to mobilize resources for development, but also to use those resources wisely. Historically, no country has entered into modern economic growth without strategic targeting. Japan and the East Asian NICs are the most recent examples. Strategic targeting is their secret weapon in beating competitors on international markets. Their cases show that comparative advantages are not always naturally endowed. Instead, they can be created, if right industries are targeted and right policies applied to strengthen their international competitiveness (Amsden, 1989; Wade, 1991). The market alone cannot promote a right structural composition compatible with the strategic goals of a nation. Industrial policy is a tool for the state to stimulate particular lines of economic endeavor by willfully shifting the industrial structure.

China is in transition from a command economy to a market economy. By definition, markets are not complete in the process of transition. Otherwise, the transition would be unnecessary. Leibenstein envisages the economy as a "network of nodes and pathways." The perfect market model would be represented by a complete net, a net in which all its pathways are well marked and well defined, and all its nodes deal with each other on equal terms for the same commodity (Leibenstein, 1978). Due to the long history of command economy and to the low level of development, however, there are countless "holes" and "tears" in China's "net." Market imperfections can be seen almost everywhere. Neo-classic economists believe that markets can perfect themselves without government action. structuralists doubt. Even if markets can spontaneously emerge from voluntary transactions between economic agents, in structuralists' view, they will at best work incrementally. The elimination of ubiquitous market imperfections will take decades to finish. That is too slow to meet the present urgent needs of everyday life and development. Government intervention therefore is needed to alleviate major socioeconomic problems during the market transition caused by market failures and market imperfections.

Moreover, the market economy has its political, ideological, and moral bases, which are what a economy in transition is generally lacking. Economic interests aside, people's behaviors are influenced by habits, conventions, ethics, inertia, and the like. They often find it hard to adapt. In the case of market transition, people would not accept market values and behave according to market rules simply because the government has announced that their country has adopted the model of market economy.

An effective government is a precondition of transition to market economy. There are three reasons. First, the development of a market economy is by no means a spontaneous process. Polanyi, in his classic study of the rise of the market in England, concluded: "The road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism" (Polanyi, 1957). State coercive power is needed in market development because the practices that are most consistent with market rationality tend to violate the "moral economy" that preexisted the market economy, which are likely to cause political disturbances (Thompson 1993). The command system in a sense was a moral economy characterized by what Chinese call "iron rice bowl" (life-time employment) and "everyone eating from the same pot" (equal income regardless of effort). To create a market economy, the "moral economy" has to be destroyed and a new ethic cultivated or imposed, which is bound to trigger off protests against the logic of market. Market development thus requires an ongoing process of "legitimatization" supported by the armor of coercion.

Second, the market transition involves not only the transformation of norms and institutions but also social dislocation and the redistribution of resources and power. Many studies have shown that "whatever their long-term consequences, in the short-run reforms are likely to cause inflation, unemployment, and resource misallocation as well as to generate volatile changes of relative incomes" (Przeworski, 1991). In the best scenario, as in the case of China, where everybody benefits, some people will gain much more than others. More likely, in the process of transition, some will benefit at the expense of others. The issue then becomes who will benefit and who will bear the costs. The government can of course use its coercive power to impose the costs on certain social groups. In order to have a relatively smooth transition, however, the state is better to adopt measures for alleviating transition pains by establishing new "safety nets" and somehow compensating those whose interests are threatened by the market. This is a very expensive undertaking. The state has to be strong enough to amass sufficient resources for redistribution.

Third, the fate of the transition depends as much on its direction as on its sequence and pace. Only a strong (and wise) government is able to guide the economy through desired sequence and control the pace of change. Some economists have pointed out that the transition from command economy to market economy cannot proceed under the adverse macroeconomic environment (McKinnon, 1991). Unfortunately, when (former) socialist countries began their reforms, none of them had established satisfactory economic equilibrium to support the marketization of their economies, and the first waves of their reforms, without exception, further damaged macroeconomic stability. Under such a condition, how reforms are sequenced is of critical importance. Mindless liberalization would only do harm to marketization.

China is a large country in which there are enormous gaps between regions, and whose population are rapidly aging. Generally speaking, the larger the size of a country is, the bigger investments are needed to install infrastructure in general, and communications in particular. Geographically, China is the third largest country in the world, after Russia and Canada. However, compared with the United State, a country that is about the same size, China's railroads and highways are only one-fifth and one-seventh of the latter's, respectively. Even India's railroads and highways are much longer than China's, though China is three times India's size (CIA, 1992). The lagged communications sector has long been a major "bottleneck" in the Chinese economy, which not only impairs the overall efficiency but also contributes to the perpetuation and even widening of the gap between the developed eastern region and the vast poor western region. Moreover, the persistence of bottlenecks could jeopardize China's future economic development and even political stability. Only the government could break those structural barriers, for individual economic agents have little incentive to provide "public goods" on a voluntary basis.

For historical and geographic reasons, there exist great variations in the level of economic development among China's provinces. By comparison with many other countries, regional disparities in China are large. The per capital GNP of the richest province is 7.5 times that of the poorest in 1991.[2] The corresponding ratios for the United States and Canada were only 1.43 times (1983) and 2.3 times (1988), respectively (Wang, 1995). Market forces cannot be counted on to narrow down such large regional disparities. Only the government is able to help backward areas to catch up by employing fiscal transfers and other policy tools.

In absolute number, China has already had the largest aged population in the world: There are 100 million people over 60. More important, the speed of population aging in China is the fastest in the world. It took some 50 to 90 years for the proportion of people aged above 65 to grow from 10% to 20% of the total population in European countries, but it will only take some 20 years in China. It is estimated that by 2040 there will be 300 to 320 million elderly people (Chinese Academy of Science, 1990). To raise funds for the social welfare of the aged will be one of the gravest challenges for the Chinese government. Private market for old-age insurance may not be adequate. That is why developed countries all have government-managed social security programs. As a matter of fact, the growth of government in those countries can to a great extent attributed the aging of their societies. Japan is a good example (Noguchi, 1987). As a self-claimed "socialist country," China will not be an exception to this rule.

For the reasons discussed above, apparently, the Chinese government cannot afford to be merely a "night watchman." Nor should its role be limited to correcting "market failures" defined by standard welfare economics textbooks. Since the degree and range of "optimal" state intervention are likely to vary in different countries and at different stages of development, it would be foolish to rigidly adhere to certain predetermined formulas.

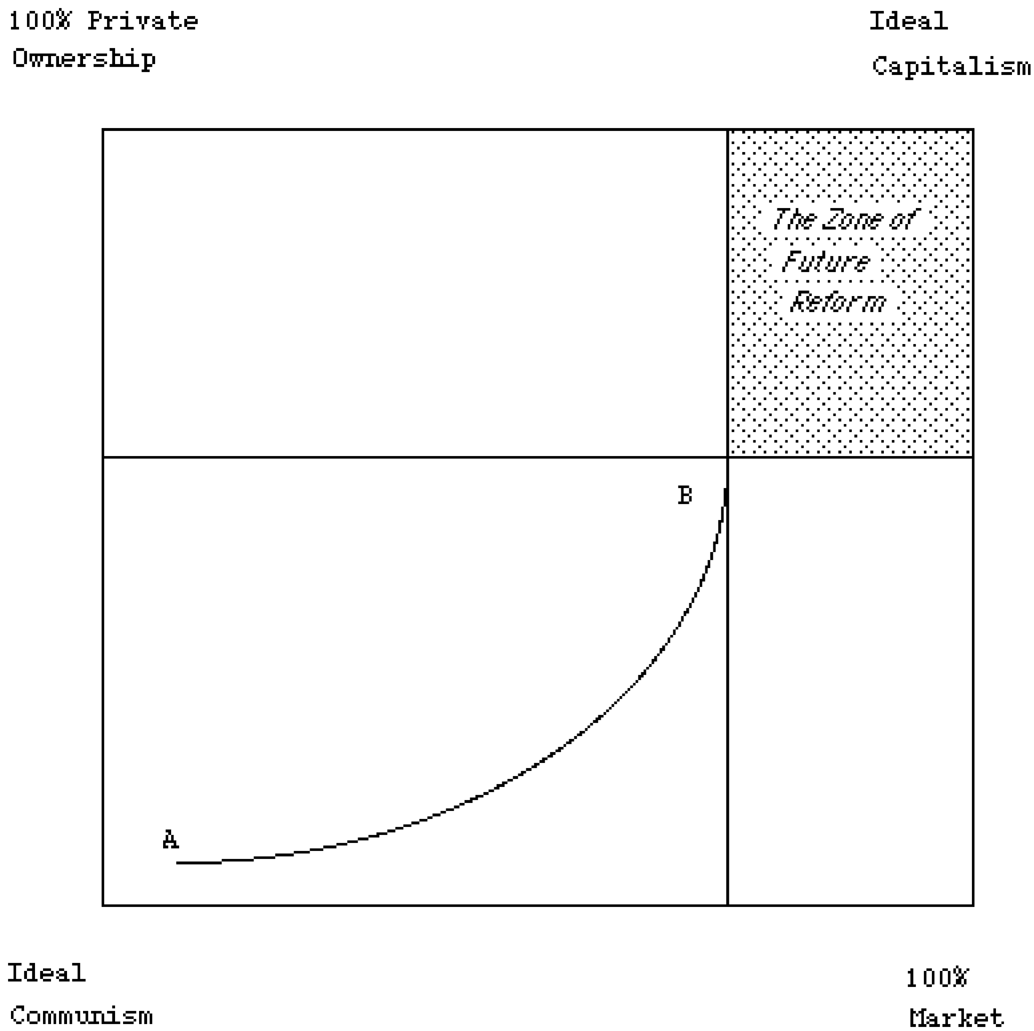
## Conclusion

The role of the state is one of the oldest topics in Western economics. Now, it is becoming one of the hottest topics among Chinese economists. The very fact that Chinese economists begin to debate on a "Western" issue signifies that two profound changes have taken place in the largest communist country. First, Chinese economists have become increasingly Westernized. The diffusion of Western analytical concepts and tools among Chinese economists has gradually transformed the discourse of public debate over the state-market relationships. Fifteen years ago, the debate centered around whether or not the market should be used as an instrument of the planning at all. But now, the term "planning" rarely appears on economic publications. Fifteen years ago, the debate was conducted entirely in Marxist language. Economists as well as top leaders had to justify their every action in terms of orthodoxy ideology. Today, however, "property rights," "allocative efficiency," "market failure," and other Western economics jargons are dominating the discussion. As far as the economic language is concerned, differences between China and the West have been rapidly diminishing.

Second, and more important, China's economic system has been largely marketized. The change of economic language is a reflection of real changes taking place in the economic system. As China's economy comes to bear more and more resemblances to Western market economies, it is natural for Chinese economists to share some common interests with their Western counterparts. Under the classic centrally planned system, the economic role of the state was never questioned, because people were used to its omnipresence. In the early years of reform, economists and policy makers began to realize that the state was not omnipotent. So, they made attempts to employ the market as a supplementary mechanism for resource allocation. At that time, however, the central position of the state in regulating the economy was still beyond doubt. Therefore, the economic role of the state did not arouse much interest. This issue began to attract a great deal of attention in China only after the concept of market had became fully legitimized and market institutions officially postulated to be the principal mechanism of resource allocation. In a market economy, every instance of government restriction of competition needs to be justified.

In the West, two centuries after Adam Smith, controversies over the role of the state still rage with similar passion. Therefore, the debate that has just begun in China is not likely to result in consensus any time soon. Perhaps, no such consensus will even be reached. That is not important. The important thing is that China is learning how to strike a balance between market and state intervention by practicing and debating. The country's growing experience with market economy will make Western writings on the virtues and defects of the market mechanism more meaningful to Chinese economists, thus enriching their on-going debate on the role of the state. Given economists' increasing influence on policy-making, the debate no doubt will make a powerful impact on the future direction of China's transformation. No matter which of the three schools discussed above will prevail, one thing is certain: China's reform has passed the point of no return. If the role of the state in the economy is to be measured along two dimensions--the proportion of resource allocated by the state and the proportion of the means of production owned by the state, the position of the Chinese state has shifted from point A to point B in Figure 1 in the course of the last fifteen years. Future changes will take place only in the gray area, which I call "the zone of future reform," because it is very unlikely for either the size of non-state sector or the scope of market allocation to contract from the current levels.[3]*

**Figure 1: The Zone of Future Reform**




*I am grateful to Thomas Bernstein, Joseph LaPalombara, and Charles E. Lindblom for their valuable comments on the first draft of the study. Of course, the author alone bears the responsibility for any errors that remain.

**Endnote**

[1]. Nina Halpern (1986) found that Chinese economists already had some influence on policy-making in the early 1980s. At that time, in her jugement, certain weaknesses in the economics discipline were the major barrier to economists' increased influence. Over the course of the last decade, much progress has been made in the sophistication of economic analysis. In the meantime, as the economy becomes more and more complicated, top leaders can no longer rely upon their own intuitions or advices from the bureaucracy in formulating economic reform measures. They have to recognize the importance of economists' inputs. As a result, what economists say carries much more weight in policy-making today than it was true a decade ago.

[2]. If Shanghai, Beijing, and Tianjin--three metropolises--are excluded from China's 30 provincial units, the gap drops to 3.2 times.

[3]. For a discussion of the shrinkage of China's state sector in the last fifteen years and a parallel on-going debate on the compatibility of public ownership and the market economy, see Wang, 1994b.