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1

Introduction

János Kornai and Yingyi Qian

Two events have provided the background for the chosen topic of this Round Table. The first is the great intellectual debate in the 1930s known as the 'socialist controversy.' At the beginning, the arguments in the debate were centred on the issue of feasibility of socialism using the market mechanism for resource allocation, but soon they were extended to the more general issues beyond. Among the distinguished participants of the debate are Barone, Taylor, von Mises, von Hayek, Lange, and Lerner. There emerged influential intellectual works as a result of the debate, the most famous being Hayek's 'The Road to Serfdom' and 'The Use of Knowledge in Society' on the one hand, and Lange's 'On Economic Theory of Socialism' on the other. It is in the latter that Lange formulated his famous idea of 'market socialism.'

The second event, one of the most important in the twentieth century, is the rise and fall of the socialist economic system. At its peak, nearly 30 countries comprising one third of the world's population practised socialism: the political and economic system characterized by central planning, public ownership, and the monopoly power of the Communist Party. Since the fall of the Berlin Wall in 1989, all of the countries in Central and Eastern Europe have made the transition to a system characterized by market, private ownership and democracy.

But two countries, China and Vietnam, seem to represent an anomaly. There is no doubt that these two countries have abandoned central planning. It also becomes clear by the turn of the century that private ownership has become a significant, if not yet dominant, force of the economies in these two countries. However, in two important aspects these two countries differ from those countries in Central and Eastern Europe. The official ideology in both countries maintains the claim to adhere to the road of socialism, and both countries continue to have

2 Introduction

the Communist Party in power guaranteed by the Constitution. China and Vietnam are too large to be ignored or simply regarded as an exception to a general trend. China, with a population of 1.3 billion, is at least three times larger than all the Central and Eastern European countries, including Russia, combined. Vietnam, with a population of over 80 million, is larger than Poland, the largest Eastern European country. Furthermore, the economies of both China and Vietnam have given outstanding growth performance so far.

The reform experiences of China and Vietnam have raised important intellectual, as well as practical, questions. Are they practising market socialism? If not, what kind of socialism are they building up? How has the market emerged under the dominance of public ownership? What is the meaning of the term 'market' in this context? How has private ownership evolved in the presence of the ideology of the Communist Party, which identifies itself with public ownership according to the orthodoxy of Marx? How will the economic development and the transformation of the structure of ownership induce legal and political change? Towards which kind of market system are China and Vietnam heading? Is there an Asian road, different from the European road, towards market and democracy?

These questions touch upon some fundamental issues concerning the relationship between market, property rights, and political system. They were addressed at the Round Table of the International Economic Association on 'Market and Socialism in the Light of the Experiences of China and Vietnam' held on 14–15 January 2005 at the Hong Kong University of Science and Technology, Hong Kong, China. This volume contains 11 chapters based on papers presented at that Round Table.

Chapter 2, by János Kornai, clarifies some conceptual confusions about the terms 'market' and 'socialism.' It serves as a point of departure for the rest of the book. While the interpretation of the concept of market is pretty standard and easy, the interpretation of the term 'socialism' is much more difficult. For the sake of the current discussion, Kornai distinguishes five different interpretations of socialism.

The first interpretation is that by Marx. Marx unambiguously advocated public ownership of means of production because he believed that it is more productive than private ownership. According to Marx, market combined with private ownership of property only means anarchy and waste. On the political structure, Marx did not appreciate 'bourgeois democracy,' and he advocated the dictatorship of the proletariat for an indefinite period of transition from capitalism and communism.

The second interpretation of socialism is the Walrasian concept of socialism. The most influential work is from Oscar Lange, whose model of 'market socialism' fits well into the framework of Walrasian economics. Market socialism means public ownership plus market. Socialism and market are compatible. The first two interpretations of socialism are the concepts envisioned by scholars, and they do not correspond to realities.

The third interpretation is Lenin's concept of socialism. This would be called 'classical socialism', which was practiced in 26 countries for a considerable time. It has three coherent characteristics: the political structure features the unshared power of the Communist Party; public ownership is the dominant form of ownership of property; and market is suppressed and replaced by the predominance of central management, or bureaucratic coordination.

The fourth interpretation is the social democratic concept of socialism, which has been practised by several Western countries since the Second World War. Social democrats unconditionally accept parliamentary democracy and do not reject private ownership. Although they advocate the market as the chief coordinator of economic activities, they are also in favour of using the power of the state for income redistribution to create the welfare state. Both interpretations three and four are socialism found in the real world, in the past or at present.

The fifth interpretation is the contemporary Chinese and Vietnamese version of socialism. Kornai makes a point that it is fairly clear that it does not fit to any of the previous four interpretations. In both China and Vietnam, private ownership flourishes, which is in fundamental contradiction to the first three interpretations of socialism. In reference to the third interpretation of Lenin's socialism, despite the fact that the political structure has remained basically unchanged, market is becoming the main coordination mechanism for resource allocation. Finally, in contrast to the interpretation of social democrats, China and Vietnam have not embraced democracy. They are not building the welfare state. Kornai then raises an important question: what is the true meaning of socialism in the case of China and Vietnam? Chapters in the rest of the book try to address this difficult question.

Jinglian Wu, in Chapter 3, reflects on the Chinese economic reform and the influence of the concept of market socialism on the Chinese reformers. The Chinese became familiar with Oscar Lange's idea of market socialism with the intermediation of the works of Polish economist Włodzinierz Brus. Brus's key concept is to replace central planning by autonomous market-regulated state enterprises in microeconomic affairs

while central planning continues to operate in macroeconomic affairs. It is a variation of Lange's idea of public ownership-cum-market. One of the Chinese reform pioneers Sun Yefang actually proposed a similar idea in the 1950s and 1960s. He proposed centralizing power on major issues (regarding extended reproduction) while decentralizing power on minor matters (regarding simple reproduction of existing funds). However, the post-1978 Chinese reform experiences have shown an interesting twist. On the one hand, official reform strategy did, indeed, proceed along this line of thought, but was mainly restricted to the urban state sector. It turned out not to be very successful. On the other hand, the unexpected success of the rural non-state sector led by the township-village enterprises (TVEs) has guided China to a different route of reform; that is, to develop a non-state sector outside the state sector. This happened to work.

Reform strategy then evolved into focusing on the development of non-state sectors. This was achieved by three means: encouraging domestic non-state enterprises, opening up domestic markets to foreign firms, and establishing experimental areas such as special economic zones. As a result of this reform strategy, non-state sectors led the economic growth. In 1978, the state sector accounted for 78 per cent of total industrial output; by 2001, the state sector accounted for less than 30 per cent of total industrial output. China's reform experience conforms to Kornai's notion of the 'organic development' of the private sector, where natural development of new enterprises in private ownership rather than accelerated privatization drives the growth. Wu concludes that the Chinese experience does not support the strategy of introducing a market allocation mechanism on the basis of public ownership, as the advocates of market socialism (the second interpretation of 'socialism') suggest. China presents a case for ownership reform together with market development in general, and organic development of new entrepreneurial firms as the main driving force in particular.

In Chapter 4, Louis Putterman observes that the Chinese reform prior to 1993 was perhaps within the framework of market socialism, as it was a market-oriented reform without privatization. But by the mid-1990s, China left its rendezvous with market socialism and headed towards a more fully capitalist economy. He argues that China's experience in the 1980s was only an indirect approach towards capitalism, because such a market socialism cannot survive unless legal, political and social constraints prevent a natural transition to market capitalism. Because these constraints were present in China only to a limited degree, China 'orbited' market socialism on its path to market capitalism.

Putterman gives two reasons for the instability of the market socialism practised by China in the 1980s. The general reason is that the combination of natural human self-interest and natural human variability with respect to intelligence, drive, and intensity of self-interest means that a market economy will quickly become a capitalist economy unless there are other barriers to capitalist forms of property. The specific reason is related to the historical context of China in the early 1990s, where external and internal influences all made commitment to market socialism unlikely. An important part of the external influence is the investment from overseas, especially the overseas Chinese from Hong Kong and Taiwan. Neither were internal intellectual currents affected by the ideas of market socialism, which remains, essentially, only a Western concept. The Chinese experience suggests that market socialism cannot be established as a lasting institutional framework.

Weiyang Zhang, in Chapter 5, disputes that state ownership is compatible with a market economy. In his view, the Chinese experiment with market socialism – that is, introducing a market mechanism while preserving the domination of state ownership – is a failure. His key argument is that competition is essential and indispensable for the operation of the market, but state ownership is incompatible with it in the sense that competition would eventually wipe out state-owned enterprises. The Chinese experience has shown that, in a state-owned economy, competition often leads to excessive competition. The fundamental reason is that the politicians and bureaucrats who exercise ownership rights of the enterprises do not design the incentives for managers in the same way as private owners. In the market economy with private ownership, capital and managerial labour markets play an important role in disciplining and motivating managers. These markets do not exist in the state-owned economy. Competition is not an exogenous phenomenon independent of ownership. Therefore, it does not make sense to argue that ownership is irrelevant as long as the market is competitive. The evidence in China shows that competition actually has led to privatization, as state-owned enterprises cannot survive for long in a competitive environment.

The joint chapter by Julan Du and Chenggang Xu, Chapter 6, examines China's experiences with market and socialism in the context of its financial market development. China developed a fairly large equity market in the 1990s. This market has two important features: the state is the largest shareholder, and the market is under administrative governance. But the authors of Chapter 6 argue that, in spite of these two features, the Chinese financial market development is inconsistent with the model of market socialism. The dominance of state ownership of the

listed companies is only a transitory phenomenon, for two reasons: these listed companies are now issuing more equities to individual investors; and, furthermore, the state shares will become tradable, and the state will sell more of its own stakes to private investors.

Du and Xu studied China's financial market development from 1990 to 2002, with a particular focus on its quota system. Under the quota system, quotas for issuing shares on the stock market were distributed to local governments. They observe a strong correlation between the previous performance of the listed firms and later quota allocations, suggesting that the quota system was a *de facto* incentive scheme to motivate local governments to select better firms at the initial public offering (IPO) stage. Therefore, the administrative governance regime with the quota system worked to substitute for the formal legal institutions, and it also prevented the worst enforcement failures. However, Du and Xu also observe that, although the initial stage of a jump-start of the stock market in China is a success, such administrative governance is not a long-term solution, mainly because it fails to monitor companies once they are listed on the market. Therefore, the administrative governance is capable of *ex ante* screening but is significantly weaker in the post-listing world. Consequently, it cannot be regarded as a workable model for market socialism.

In Chapter 7, Carsten Herrmann-Pillath, using the concept of 'economic culture', proposes an alternative explanation for the Chinese experience with market and socialism. His chapter focuses on two cases concerning the rural economy to demonstrate the evolution of property rights under socialism. The first case concerns property rights on land. Even today, rural land is still defined as 'collectively owned'. But the land use rights are effectively private. He argues that the continuation of collective property served as a guarantee of a particular distribution of land use rights in the rural population which stabilized expectations about the future outcome of reform. Stability of collective property rights also served as an anchor to link migrant workers to their home areas. His second case concerns rural industrialization, where the preservation of collective ownership in TVEs was an efficient institutional solution to industrialization in an uncertain environment at the time. He argues that the rise and decline of TVEs is a case of path-dependent gradualism, where changing performance triggers institutional change.

Barry Naughton, in Chapter 8, studies how China's political hierarchy has shaped China's transition from planning to markets. Naughton points out that although nearly all transactions are carried out through the market, it is still the same political hierarchy that commands ultimate

political – and, in some respects, economic – authority. Using a multi-task principal-agent model, Naughton's analysis centres on how the Chinese political hierarchy adapts to changes in the economic environment.

In the first phase of reform, from the late 1970s to the mid-1990s, this hierarchy was 'incentivized' through a series of decentralization initiatives. This is viewed as a necessary response to the introduction of the market. It turns out that the strengthened incentives within the hierarchy also provided the underpinning of the dual-track economic system at the time. Naughton argues that it is precisely this complementarity between the incentivized hierarchy and marketization of the economy that explains the Chinese success of reform in this period.

But this complementarity became obsolete around the mid-1990s and, as a result, the Chinese government changed its strategy in the second phase of reform, from the mid-1990s to the present. It abandoned the dual-track strategy and moved in the direction of a 'regulatory state', with a significant recentralization of management and regulatory power within the hierarchy. The government bundled tasks into more specialized and more clearly partitioned jobs within the hierarchy. This restructured hierarchy is a response to the reality that the economy has already grown beyond the initial plan. However, Naughton is worried that even the restructured hierarchy might not adapt well to the Chinese economy in the future, when the tasks become more complex as China moves to middle-income status.

The subsequent three chapters are about the Vietnamese experience of reform. Le Dang Doahn, in Chapter 9, provides a historical background for the evolution of the market economy with a socialist orientation in Vietnam. Vietnam was influenced by the Soviet Union and China, first in the North, after 1950, and then also in the South, after 1975. The path of economic reform taken in Vietnam resembles that of China, where the turning point was a new Party policy of *doi moi* (renovation) pronounced in 1986. As in China, the 20 years of reform have been very successful. The similarity of the nature of reform between Vietnam and China is remarkable. As in China, the market-oriented reform is also mainly driven by small private enterprises, while the government continues to insist on performing the fundamental role played by the state sector. Vietnam does not seem to follow the path of market socialism either. But, unlike China, the Communist Party in Vietnam does not allow its members to participate in private businesses.

In Chapter 10, Vo Tri Thahn focuses on the post-1986 period in Vietnam, especially the period after the major 1989 reforms. In responding to serious macroeconomic instability, in March 1989 Vietnam

adopted a radical and comprehensive reform package aimed at stabilizing and opening up the economy. The macroeconomic stabilization package is a sort of ‘shock therapy’ similar to that in some of the Eastern European countries at the beginning of the transition. It worked well. Other than that, reforms in Vietnam were remarkably similar to China. Most radical reforms were carried out in the agriculture sector. Household farming replaced cooperatives, and long-term land use rights were granted to farmers to create strong incentives. Similarly, the government encourages domestic private entrepreneurs as well as foreign direct investment (FDI). Rapid growth in services and construction mainly came from the rapid growth of private enterprises. Also, as in China, the reforms in state-owned enterprises and state banks have been limited, despite huge efforts from the government.

What are the lessons from the Vietnamese experience? Vo argues that, fundamentally, economic reform is about granting rights and enlarging opportunities for people so that they can choose and decide the directions and forms of production and business activities that they will pursue. In Vietnam, it is also true that the Communist Party’s leadership is the most decisive factor for guiding *doi moi*. But why does the Party insist on the concept of ‘socialist orientation’ when it pushes for market-oriented reform? Vo explains the three dimensions for which ‘socialist orientation’ really stands.

The first dimension concerns the leading role of the state sector in the economy. Unlike market socialism, the state sector might not play a dominant role in the economy, but it has to play a leading role. The government does not want to give up that role. The second dimension is the concern about income distribution, specifically the gap between the rich and the poor. It is a concern reflecting the popular hostility against the rich and reflection of the traditional egalitarian tendency in society. The third dimension concerns the goal of a strong nation, which echoes nationalism.

In Chapter 11, Steve Parker takes up the discussion on Vietnam from a different angle, focusing on Vietnam’s economic integration with the world. Parker identifies two phases of integration. The first phase runs from 1986 to approximately 2000, the 15 years of relatively gradual reforms. Systematic reforms accelerated from about 2000 to implement the US–Vietnam Bilateral Trade Agreement (BTA), which opened the US market for Vietnamese exports; to implement the ASEAN Free-Trade Agreement (AFTA); and to prepare the accession to the WTO. These three trade agreements provided critical benchmarks, focus and incentives for adjusting Vietnam’s legislation, regulations, and administrative

procedures in order to conform to international standards and best practice.

The distinct feature of the Chinese and Vietnamese experience is that market and ownership reform occurs contemporaneously with the persistence of the Communist Party's monopoly of power. The joint chapter by David D. Li and Yijiang Wang is an attempt to explain the striking difference between Eastern Europe and the former Soviet Union on the one hand, and China and Vietnam on the other. The experiences of Eastern Europe and the former Soviet Union seem to demonstrate that socialist political and economic systems are coherent, consistent, and intertwined with each other. Market-oriented reform is doomed to fail without fundamental political change. The chapter asks a difficult question: why have Chinese and Vietnamese market reforms worked so far under the rule of the Communist Party? The Chinese and Vietnamese experience is a puzzle, considering what has happened in Eastern Europe.

Li and Wang argue, in Chapter 12, that the initial political conditions in China and Vietnam are fundamentally different from those in Eastern Europe and the former Soviet Union. The Communist Parties in China and Vietnam came to power after long and brutal military action, and thus enjoy an extraordinary level of political and military control. Such control was reinforced by the existence for thousands of years of a feudalistic social structure. Having strong initial political control, the Communist Parties there can afford the moderate easing of political control over economic reform without needing to be concerned about losing power completely. By contrast, in Eastern Europe and the former Soviet Union, economic reforms in the 1980s ran into political barriers and further reforms were impossible without radical political change.

Let us summarize the lessons. The participants did not draw final conclusions. Nevertheless, there was a tacit consensus concerning China, Vietnam and 'market socialism'. *Yes*, both countries are more or less market economies, or close to being market economies. And *no* – neither country can be called a 'socialist system', by any usual definition of the term 'socialism'. The use of this concept is only a characteristic component of the rhetoric applied by the ruling elite of these countries.

While there was a consensus in that respect, the discussion did not lead to conclusive predictions for the long-term development of these countries. The present situation of the state sector of production seems to be unsustainable. But nobody can make strong predictions as to where that leads. To further shrinking in relative, or even in absolute, terms? Or to stronger efforts by the government to force the survival of the state sector by using all its means of political and economic power?

Even less settled is the question of the political future. Participants were sceptical with regard to a mechanical response from the political sphere to changes in the economic sphere; in other words, that the movement in the direction of private property and market coordination will automatically generate a movement towards democracy. But the prospect of a slow and gradual shift towards the state of law and, finally, towards democracy is certainly not out of the question.

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