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TWENTY YEARS OF REFORM: ACHIEVEMENTS, CHALLENGES, AND THE NEW AGENDA

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§1. Introduction

During the last twenty years, China has seen the most remarkable period of economic growth in modern times. There is cause for celebration, but there are also new challenges. China's very success has propelled it into a new phase of reform, and that is the focus of my talk. China's development in this period has been characterized by a sequence of radical changes, although it has also been evolutionary in the sense of building on what went before. Where the territory was uncharted, the government recognized that it was unknown and approached reforms with a pragmatic learn-as-you-go spirit. It did not matter whether the cats were black or white as long they could catch the mice—and some experience was needed to see which cats could actually catch the mice.

We might very roughly divide China's reforms into three phases: the agricultural reforms (1979-1985), the development of rural industry and the township-village enterprises (TVEs) with partial opening to foreign trade and capital (early 80s to mid 90s), and now the third phase of deeper opening to the global economy and growth which will be increasingly driven by the private sector. The first two phases relaxed constraints and released people's energies in agriculture and rural industry. Now the challenge has become the building of the institutional infrastructure that will release the full productive forces of a well-functioning market economy, while retaining the social cohesion which has been a foundation of past achievements.

[1] For assistance with this speech, I would like to thank Deepak Bhattasali, David Dollar, Mark Dorfman, David Ellerman, Athar Hussain, and Halsey Rogers.

Let me begin by taking a backward look at some of the reform principles behind the successes of the last twenty years. In so doing I will draw some contrasts with less successful reforms elsewhere.

§2. Understanding the Last Twenty Years

The Chinese economy presents a mixture of features of a market economy intertwined with those of a command economy. Within this changing mixture, three institutional elements were central to the last twenty years of reforms: decentralization, rural reforms, and experimentation and innovation with new enterprises (e.g., TVEs). Each element is crucial to an understanding of how China was able to use its social and organizational capital to transform the economy and generate growth. Decentralization of decision-making, in its many facets, allowed experimentation and innovation without massive dislocation. The large agricultural sector saw fundamental decentralization at the outset of the reform period. As a result, this sector provided productivity growth in the early stages of China's transition and a source of labor for industrial growth over the whole period. In turn both the agricultural decentralization and the rural institutions and traditions provided the basis of the new, largely collective, rural and industrial enterprises that drove China's growth from the mid-1980s.

The analysis of decentralization, the rural economy, and new enterprises provides a context and rationale for China's successful evolutionary approach to the transition, which may be summarized in a stylized way in terms of four principles or observations.

1. Step-by-step Progress: The Chinese experience shows that an adaptive process of transition, proceeding step by step, can retain the social and organizational capital developed in previous stages of development and transform it in ways that enhance efficiency and productivity. Sometimes the step-by-step or incremental approach is misunderstood as being "gradual" or slow. Yet the agricultural reforms of 1979-1985 probably represent the largest successful social and economic change in such a short time period in history. The reforms grew out of bottom-up experiments that were based on people's living memories, spread horizontally in a process of social learning, and then

were scaled-up and completed by the government. By contrast, the Russian attempt to "legislate," almost instantaneously, a large array of institutions for a market economy (of which the population had no living memory) is likely to result in a path which takes much longer to reach the goal of a well-functioning market economy. The processes employed in Russia led to the further deterioration of the already frail social capital and institutional structures, and the weakening of incentives for innovation, investment and structural change. In Karl Popper's terms, the Russian experience embodied an attempt at "utopian social engineering" while the Chinese proceeded in a spirit of "piecemeal" pragmatism.

2. Build the Road as One Travels: There were strong arguments in favor of following such an evolutionary approach, arguments based on information, behavior, and understanding. At the outset of a reform process, it is not possible to foresee, let alone to resolve, all the problems that will emerge at later stages. Thus change must be a process of adaptive learning, not a process of following a fixed blueprint. The French have an expression that one learns *chemin faisant*—one learns as one goes. In the June 13, 1987 *People's Daily*, Deng Xiaoping said:

> "Generally speaking, our rural reforms have proceeded very fast, and farmers have been enthusiastic. What took us completely by surprise was the development of township and rural industries. All sorts of small enterprises boomed in the countryside, as if a strange army had appeared suddenly from nowhere. This is not the achievement of our central government. Every year, township and village enterprises achieve 20% growth. This was not something I had thought about. Nor had the other comrades. It surprised us." [Quoted in: Becker, Jasper 2000. *The Chinese*. New York: Free Press. p. 68]

3. Climb the Mountain by a Zigzag Path: The reform path might be more zigzag than linear. For example, at some stage in the evolution it might be desirable to decentralize further, and yet at a later stage to re-centralize. Financial institutions that have a social welfare role might be a help to reforms in the early stages, but can then become a hindrance at a later stage. Elements of success in the past may become inappropriate or obsolete for the present or future economic strategies. For instance, TVEs which have been key to the

rapid growth in the coastal region, may not necessarily be appropriate vehicles for the development of the lagging western regions: compared to the coastal regions, much of the western region is sparsely populated and the dense population of the coastal regions was a key element in the building of successful TVEs.

4. Robust Solutions: The solutions to problems, as they arise, need not be perfect: indeed, even if perfectly fine-tuned to one stage in the transition, they would not be so perfectly matched for the next. The key is to look for *robust* solutions, that is, resilient solutions that work reasonably well across, or can be adapted to, a range of circumstances.

As China moves forward along its own reform path, it is important to remember and maintain these broad general principles. Many of the failed reforms in some other transition economies were based on the false hopes of finding short-cuts that would produce institutional reforms almost overnight (voucher privatization being one example). As new challenges arise, it is important that China avoid the temptation to grasp for panaceas. New solutions will have to be found, but in the search for the new solutions it is important not to abandon the basic principles that have proved so successful up to now.

While an economically successful individual might look forward to relaxing and enjoying a well-earned retirement, this is never true for a country as a whole. China's recent successes are cause for reflection and appreciation but they should not lead to any relaxation in the reform efforts. The nature of the reform process changed and will change across the three phases. The first phase (agricultural reforms) was more planned and built upon living memories. The second phase (TVEs) was less guided, more experimental, and built upon some recent institutional experience. Now the reform path leads into new territory. This is characterized by a continuation of: unfinished old reforms (e.g., reforms of the financial sector and of the state-owned enterprises or SOEs); adverse side effects (e.g., lagging regions and sections of the community, budgetary problems, environmental deterioration, problems in grain markets, excess capacity in TVEs, and major problems in health and education); and new reform challenges.

Here it is important to emphasize "the zigzag path up the mountain." In the earlier phases of reforms, the financial system, in a sense, maintained the social safety net by accommodating the SOEs and other collective enterprises in an enterprise-based system of social support (e.g., housing, medical care, and pensions). Moreover, the TVEs carried the burden of new growth. In the new phase, the unreformed financial institutions and SOEs are no longer appropriate, indeed are becoming major burdens, and the TVEs will need to undergo radical change if they are to survive in a more competitive environment.

§3. New Challenges

What are some of those challenges? The primary new challenge is increased competitiveness as the old sources of productivity growth, such as the energy released by relaxing the constraints of the command economy, are running out and as the problems of side effects grow. The special problems of reducing poverty, particularly rural poverty, are addressed in my speech Overcoming Poverty in China given at Beijing University this week.

The second broad challenge is job opportunities. Estimates vary considerably, but during this decade well over a 100 million new job opportunities will need to emerge to employ people no longer needed in agriculture, people being shed from the SOEs and TVEs, and people newly entering the workforce. This sort of growth of opportunity can come in a sustainable manner only from a deeper opening to a market economy, not by expansion of public sector employment.

Private sector growth on a larger scale will require major reforms in the financial sector, the service sectors, and in infrastructure (e.g., telecommunications and power). I will try to draw out later possible mechanisms for fostering the growth and reforms by improving the climate for domestic and foreign investment and for empowering people to use their own initiative to shape their economic lives.

In thinking about the necessary sectoral reforms we must recognize that institutions that are supportive in one phase of reform may, if unchanged, become fetters for the next phase. A caterpillar might do well in its own environment, but it must undergo great changes to become a butterfly. The new reform agenda requires such a metamorphosis. Central to the metamorphosis to a market economy will be financial or social arrangements which are consistent with the effective functioning of markets. This will involve separating many of the financial and social functions of existing enterprises and banks so that China will eventually have:

- banks that make loans for business purposes—they cannot continue supporting the social burden of the SOEs and remain viable as banks,
- social expenditures "out in the open" and on budget without weakening the incentives for success at the enterprise level,
- enterprises that operate flexibly on a market basis (not as all-inclusive and rigid providers of local public goods),
- housing, schooling, and medical care decoupled from enterprises so that labor can move in response to changing opportunities, and
- a social security system that is decoupled from enterprises so that enterprises can be restructured, and that provides the population with a level of protection which is adequate to maintain social cohesion and supportive of entrepreneurial risk taking.

These are major challenges, but the response is made easier by the successes of the last 20 years. There is now a new economy “out there” that can draw in factors from restructuring or declining entities, and can provide a basis for taxation.

At the same time, there are challenges to be met—and opportunities to grasped—as China opens to international competition with its entry into the WTO. In the earlier stages of reform, China gained by opening up trade between regions that were relatively self-sufficient (in contrast to the hopelessly rigid and over-integrated system of the Stalinist organization of production inherited by the countries of the former Soviet bloc). These "gains from internal trade" were an important part of China’s growth story. And China gained from external trade as well, benefits that should increase with entry into the WTO. That is one of the key opportunities to be grasped. And the

impact of China's entry will reach well beyond China. The world has much to gain from China's taking its place within the WTO, and more generally shaping the future of the international economy.

More global competition inside China will bring adjustment within sectors, with better firms succeeding and expanding while many of the weaker firms will fail. There will be more exit (bankruptcies and closures) and more entry (new start-ups and spin-offs). There will be much more labor mobility. In the United States, over a five-year period, one in three manufacturing firms disappears and is replaced by a new entrant. In open developing countries turnover rates among firms are even higher. Much of the benefit of globalization comes from this dynamism: lots of new firms starting up, some succeeding, but many failing. In order for China to benefit fully from globalization, it needs institutions that support these birth and death processes, or "churning," of firms and that provide protection for workers. All this highlights both that now is the time to take on the older unfinished reforms such as the restructuring and transformation of the large SOEs and the need to enhance the flexibility in all the factor or input markets (land, labor, capital, and services).

Let me look at some of these new challenges in greater detail. I will take a closer look at (i) enterprises and competition (including the issues of entry, restructuring, and exit), and comment briefly on (ii) regulation and infrastructure (including the financial sector), (iii) WTO accession and trade issues, and (iv) social protection.

(i) Enterprises, Competition, and the Investment Climate

Entry: SMEs as the Engine of New Growth and Job Opportunities

Economic vitality must come primarily from within—from improving the domestic investment climate to release more and more of the creative and entrepreneurial energies of the Chinese people. I have developed ideas on the investment climate at greater length in another lecture this week at the People's University, so I will not examine the concept at length. Instead, I would like to relate it to the growth of enterprises—particularly small and medium enterprises. By the

investment climate I broadly mean (i) stability and openness, (ii) governance and institutions, and (iii) infrastructure. I will focus mainly on the second broad element.

Why does government impose so many regulations and restrictions on the entry of new formal businesses? One reason is that the government at the national, provincial, city, and local level keeps wanting to act like the controlling "parent", trying to protect the "children" from any possibility of getting hurt or doing damage. New businesses have to pass all sorts of tests and jump over all sorts of hurdles to be sure that they are sound and can be allowed to walk without holding a parent's hand. But I am afraid this approach is unlikely to foster strong, dynamic and entrepreneurial enterprises; we need a new "mental model" that focuses on the investment climate for spawning new businesses.

Government intervention should be enabling rather than restrictive or paternalistic (e.g., reforming the banks to make small business loans or reforming movement restrictions so workers can go where jobs agglomerate). This might at first sight seem callous, but let us remember that it is the standard of living of people that matters, not the survival of specific firms. Enterprises and the structure of industry are elements in the provision of opportunities and productivity growth. Competitive markets can drive that productivity growth but they also drive structural adjustments in troubled firms. That is why some elements of social protection are not just "social programs" but are key economic components in a vigorous market economy. In short, we would say: "*Support and invest in people; do not protect and restrict firms*."

The reform efforts in Eastern Europe give many negative lessons—such as avoiding attempts to build institutions from scratch overnight—but there were also some positive lessons. One was the vitality and overall success of the small and medium-sized enterprise sector in countries such as Poland and Hungary. The leading Hungarian economist, Janos Kornai, was one of the few who from the beginning emphasized not only evolutionary growth but the focus on the SME sector as the driver of growth.[2]

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[2] See Kornai, Janos 1990. *The Road to a Free Economy. Shifting from a Socialist System: The Example of Hungary*. New York: Norton.

I have already emphasized the importance of removing paternalistic restrictions so that new small businesses can flourish. What are the other sources of the emergence and development of SMEs?

SMEs come not only from "below" (start-ups) but also from "above"; SOE reform can be a source of both medium-sized firms (spin-offs or break-ups) and small-businesses. Medium-sized firms could arise from major product lines or components of the original SOE. But the small businesses spawned by an SOE could come from any part of the business that could be done contractually by a small business. For instance, trucks or vans could be sold over time to their drivers, who would then have small transportation businesses serving not only the original firm but taking on other business and other workers. [3] Similarly, the vehicle repair shop in the big firm could be reorganized as a small business providing services to the firm. In this way, many parts of a large SOE could be separated off into small or micro-businesses, which would then be energized to grow and take on other business.

Some impediments to the investment climate come from central government, but many are local. Thus, local governments should work to reform the investment climate for SMEs by simplifying, making transparent, and expediting the process for new business start-ups and spin-offs. With a clear public mandate from above to improve this local business climate, associations of small businesses can be encouraged to bring ideas to, and pressure on, the local governments from below. Such a movement from above and below is key to getting the job done.

Another part of an enabling investment climate is empowerment through education and training. With either new start-ups or spin-offs, managers and entrepreneurs will largely be adults who

[3] Such micro-spin-offs were part of the restructuring program at the Ispat-Karmet Steelworks in Kazakhstan supported by the EBRD and IFC.

have already been working but who have little experience running a market-based enterprise. Hence we should recognize the importance of retraining people for micro-, small, and medium-sized businesses. Public or private adult education organizations and extension services should address this challenge. Here is where the new information technologies for distance learning could also be helpful. Since many of the people who might hive off or start up small businesses would have no prior entrepreneurial experience, Chinese versions of the franchise system (pre-packaged systems of business routines) might also facilitate the process.

Exit: Creative Destruction

In his grand vision of market-driven development, Joseph Schumpeter used the phrase "creative destruction" to emphasize that both birth and death are part of the process of economic life. At the level of society as a whole, there is a process of "creative destruction" that carries from one stage of reform to the next. New creations will make old institutions or methods obsolete.

Creative destruction is also needed at the micro-level of the firms. When the generation of new opportunities is such an imperative, it might seem contradictory to emphasize the need to develop workable bankruptcy procedures. But it is a non-antagonistic contradiction. Jobs maintained only through subsidies to postpone bankruptcy are sterile jobs: they will lead to no new growth, and they cannot multiply. By streamlining the mechanisms to restructure or recycle the old assets and to retrain the workers, many more new opportunities—real opportunities—can be created.

Since I am sure you have heard enough general lectures from western economists about strengthening bankruptcy, let me make two more specific points. One of the social virtues of restructuring big companies into a number of medium-sized companies (e.g., spin-offs) is that it facilitates enforcing the hard-budget constraint by making the smaller companies "bankruptable," whereas the original large SOE could play the too-big-to-fail game. Middle managers face choices between “leaving” or “staying” that the government needs to tilt in favor of the spin-offs: there is greater freedom and capacity to innovate with the spin-off. And the discipline of the budget constraint is tougher.

The second point is that when companies go into liquidation bankruptcy, the physical premises of an old factory can be turned into an "industrial park" for new small businesses started by the entrepreneurial middle managers, engineers, and workers using part of the old space, some of the old equipment, and employing some of the old staff. That also preserves some of the viable bits of the organizational capital from the old firm. In a transition economy, bankruptcy and new start-ups should not just be two separate processes but, wherever possible, two sides of the same coin. And after a few success stories, this form of bankruptcy together with start-ups will begin to relieve the social pressures against bankruptcy and make it easier for the restructuring process to go forward.[4]

Enabling SME Growth: the Service Sector

Removing paternalistic restrictions and red tape on small business start-ups is only part of improving opportunities for small and medium firms. While large firms might try to internally supply many of their needs, small and medium-sized businesses everywhere need a number of complementary services which they cannot afford to staff internally such as accounting, auditing, valuation services, marketing, design, engineering, training, information processing, equipment repair, and, of course, financing.

Many of these services such as marketing and external auditing had little previous role in the command system, and few if any of these services were supplied by independent small companies. Hence one should see the service sector as a source of growth of the market economy in its own right as well as a necessary part of the growth in the SME manufacturing sectors. Some of this growth in the service sector can come from the entry and expansion of international service firms. But much of the service sector growth will or should come from spinning off the service units and staff functions from the large companies that become less vertically integrated. The service units could become independent businesses contractually supplying these services to their original unit but also supplying a broader range of customers.

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[4] Some economists might complain that this sort of liquidation emphasizing new jobs for the old staff is "inefficient" and that the assets should be auctioned off to the highest bidder. But that sort of narrow "textbook efficiency" may never get beyond the textbooks if social pressures block such liquidations.

Enabling SME Growth: the Financial Sector

In the financial sector, I do not need to tell you about the challenges of non-performing loans and the continuing need to restructure financial institutions to operate in a market economy.[5] I would like to emphasize small business finance—both trade and longer-term finance—since, as I have argued, small businesses will be an important driver of new growth and job opportunities.

Commercial lending on a sustainable basis is not a practice that can be installed quickly by following a checklist. Seasoned experience and mature judgment are key elements in the banking business, and those human skills can only be developed over the years. It is important in this process to encourage learning between the banks that successfully develop the SME banking business and the banks that are lagging behind.

(ii) Infrastructure and Regulation

Infrastructure Services

Let me now turn briefly to the infrastructure that enables and complements private sector growth, the regulatory mechanisms that provide the framework for growth, and some of the emerging corporate governance issues.

Most of the large SOEs and many TVEs embody substantial economic and social integration—with their own sources of power and their own facilities for housing, schools, health care, and recreation. The strategy I am suggesting of restructuring large firms, where appropriate, into a group of more medium-sized firms requires that this infrastructure also be restructured so that the spun-off units will still have access to services. In part this might mean privatization, as in the case of apartments, or transfer of the function to an appropriate level of government (in the case of health services or schools).

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[5] Please see our new policy research report: *Finance for Growth: Policy Choices in a Volatile World.* Washington: World Bank, 2001.

Small and medium-sized businesses have to depend on these infrastructural services being externally supplied from the beginning. As China moves from the agricultural reforms and the TVEs to the third phase of full private sector growth with the private SMEs as the main drivers of growth, it is important that the infrastructure of telecommunications, power, and water keep pace with or enable the new growth. This will be helped if there is a pragmatic spirit for both public-private and Chinese-foreign partnerships. Various ways of accelerating infrastructure growth should be examined to see what works best—we should not be formulaic in insisting on particular "imported" models.

Infrastructure development is of particular importance in rural growth and the dynamics of regional growth. What new forms or partnerships will help spur new infrastructure not only in rural areas but particularly in the western regions of the country? The independence of decision making and shifting of attention to the TVEs may in many cases have directed collaborative energies away from local infrastructure and public goods.

Regulatory Policies

With the full opening to private sector growth, the government does not fade away. Its relationship with production activities changes from owner and manager to regulator and referee. Developed and developing countries display a rich variety of effective regulatory structures. There is not one blueprint but there definitely are some common principles that should inform and guide regulatory experimentation and practice.

You know about the World Bank's role in financing infrastructure, but our role as a "knowledge institution" is sometimes less well-recognized. But in fulfilling that role it must be remembered that "answers" or "solutions" vary greatly across countries with different institutional histories and at different stages of development.

The World Bank as a knowledge institution is working to build the capacity of "learning to learn" in the developing countries so that their knowledge institutions can better learn from *any*

source—from their own experience, from the practical experience of others, and from the experts across the globe.

I am happy to say that the World Bank Institute has helped develop just this type of learning institution, the *Research Center for Regulation and Competition* (RCRC) of the Chinese Academy of Social Science. The RCRC gathers knowledge about infrastructure regulation and competition from practitioners and academics across the world (including from the World Bank) and then works with the government to apply this knowledge to the Chinese circumstances. The RCRC is currently working with the government on telecommunications reform, railway reform, and the reform of administrative law. In the last two years, the RCRC has published six books and over twenty articles in Chinese journals, and has carried on training programs for academics and practitioners across the country.

Corporate Governance Issues in SOE Reform

The reform and transformation of SOEs is one of the key unfinished challenges. Much else depends on it. The experience in the former Soviet Union points strongly to the importance of corporate governance issues, both for transformed SOEs and for new enterprises.

Let me begin with a warning about misinterpreting western experience with large publicly traded companies. We sometimes hear about stock market flotation (often called "ownership diversification") as being some sort of "solution" for SOE reform. Where does this idea come from? When one looks at North America or Europe, one might see strong companies floated on the stock market. But one should not infer that the companies are strong because they are floated. Some part of the causality is in the opposite direction; because the companies are strong, they can be floated on public markets.[6] To put it the other way around, one should not think that public flotation is an automatic cure for a near-bankrupt SOE in need of major restructuring.

[6] "Therefore, although the stockholding system appears to be effective in some state enterprises, the causality may not run from the stockholding system to efficiency. Instead, it may be just the reverse." [Lin, Justin, Fang Cai and Zhou Li 1996. *The Chinese Miracle*. Hong Kong: Chinese University Press. 144]

Moreover, public flotation is not a solution to the "too big to fail" problem. Even in America, some large publicly traded companies such as Lockheed and Chrysler have been bailed out by the government when they were on the edge of bankruptcy. Given the legacy of iron-rice-bowl expectations from the past, I can well imagine the Chinese government having even more pressure to bail out large publicly traded companies that are perceived as "too big to fail."

There is a third problem with public flotation. Some managers seem to be pushing it because they see it as a way to issue stock options to themselves and then to cash them in to reap large windfall profits. Such profits, if they materialize, may simply be a transfer of public assets into private hands at no charge—part of “stealing from the state” and other shareholders. The stock options might focus managers more on manipulating the stock price (often a possibility in emerging markets) or the price conditions for the options to be profitable rather than focusing the managers on the more difficult restructuring tasks necessary to make the enterprise viable in a more competitive world. Long-term and stable stock ownership by managers or more broadly by employees in the enterprise would be quite a different matter as it would align incentives with restructuring and growth of the enterprise, not focus attention on short-term manipulation of share and option prices.

Thus a plan for SOE reform based primarily on floating the shares on public stock markets—perhaps with managers having stock options—is not going to drive deep long-term structuring, nor is it even going to stop the practice of bailing out companies seen as "too big to fail."

The focus of SOE reforms should lie elsewhere. The SOEs from the old non-market economy are often too big; through spin-offs and break-ups, the average size of companies should be reduced (even if they later recombine in new ways). One possibility is for the SOEs to be broken up into groups of contractually related medium-sized enterprises. Vertical pyramid structures with the fathers having control of the sons are less likely to be attractive, since the point is to decentralize control to foster innovation and new combinations.

How might this improve the management of companies? The first point is that the smaller units would have real freedom to strike new contracts with other firms and in other markets. The second point is that much real restructuring may be easier in smaller units than in large ones—small ships can make sharper turns than large ones. Moreover, it is easier in smaller units to rebuild the workplace culture from that of a state enterprise to that of a market-oriented firm. Thirdly, if a large SOE is broken up into medium-sized parts, the new CEOs of the smaller parts are likely to be younger or more entrepreneurial people. This infusion of new blood into a leadership role could promote more restructuring. It could also bring a longer-term perspective—particularly when coupled with stable share ownership. The older top managers in the large SOE might have the "age 59 problem" resulting from their imminent retirement,[7] while the younger CEOs, managers, and technical staff in the medium-sized units would look forward to more years with the company before retirement.

(iii) WTO Accession and Trade

The questions of regulatory reform are closely related to trade reform. China has made extraordinary reforms in its trade policies. Tariff rates are a third what they were a decade ago. Non-tariff barriers are a sixth of what they were. From a number of perspectives the remaining steps in arriving at a WTO agreement are relatively small compared to what has already been achieved.

I have already argued that WTO accession provides both new challenges of global competition and new opportunities for gains from external trade on global markets. In any government undertaking many simultaneous reforms, there is always the danger that the many pressures to protect old interests will lead to paralysis and stagnation. But the WTO accession for China, like

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[7] This was a problem with the Russian reforms. "For instance, privatisation without restructuring left the enterprises in control of people in their 50s; the absence of well developed capital markets meant that they were unlikely to be able to reap the benefits of any improvement in enterprise performance upon retirement (by selling shares at increased prices). Even in the case of listed shares, the vagaries in share prices meant that extracting returns from higher share price as a result of improved corporate performance was a highly risky matter; there were far more certain returns from asset stripping. Breaking enterprises up would have put more of them under the control of younger managers, who would have had longer time horizons." [Hussain, Stern, and Stiglitz 2000. *Chinese Reforms from a Comparative Perspective*. In: *Incentives, Organization, and Public Economics*. Hammond and Myles (eds.) New York: Oxford University Press. p. 249 fn. 15]

the EU accession for Eastern Europe, is like a wind that fills the sails of reform and keeps the ship moving in the right direction.

(iv) Social Protection and Pension Reform

The opening to a deeper market economy will highlight the need for a different kind of social protection. The role of social protection in a market economy is sometimes misunderstood. First, the purpose is to protect people, not enterprises. Second, it should not be viewed narrowly as a "welfare program" for those without any other means of support. At the end of the day, the best social protection for the great mass of society is a growing economy. Thus social protection should be seen as a way to facilitate change and learning—not as a way to cover the costs of failing to learn or change.

Social protection should also go well beyond the passive role of a safety net to a more active role of retraining to "bounce" the person back into the productive economy so they are empowered to shape their own economic life—rather than grow dependent on a welfare system.

Beyond the years of economic work, the elderly must depend upon informal systems of family support or more formal systems of pensions for their income. China has had a pension system for the state sector employees. Traditionally the system has been financed and managed by enterprises. The marked deterioration in the financial position of the state sector since the mid-1990s has made the system dysfunctional. It imposes a heavy financial and administrative burden on enterprises and hinders their restructuring. Moreover, the system is not able to pay pension to retirees on time. These problems are recognized by the Chinese leadership. The management of the system is being transferred from enterprises to city government and single source financing by enterprises is being replaced by a three-way financing by enterprises, employees and the government.

In terms of design, the new pension system makes substantial progress on the main requisites of a good pension system. But the new system is rendered non-operational by the massive overhang of unfunded liabilities of the old system. The result is a hybrid of the old and the new system. The partial funding of future pensions provided in the new system does not work in

practice because all of the current contributions are used up to pay for current pensions. Moreover, the city-based system is, for most cities, too decentralized to provide adequate risk-pooling. The aim of building a province-level system remains yet to be implemented.

Here I would like to emphasize the importance of formulating a concerted strategy to tackle the problems of the transition from the old to new system. The ways of meeting the unfunded pension liabilities of the old system have been under discussion for some time. It is crucial to decide in favor of a particular plan soon because the financial overhang, rather than remaining constant, is increasing. Possible sources of funding pension liabilities include proceeds from the sale of state assets, including those from the sale of equity stakes in state enterprises, general tax revenue, and issuing bonds.

§4. Concluding Remarks

From the agricultural and rural industrial reforms, China now moves into a third phase of reforms to open up to a global market economy and growth being increasingly driven by the private sector. The earlier reforms built on past memories and operated more by removing constraints to release energies than by building new institutions. But now those elements of the past are no longer prologue, and the challenges have moved on.

I have grouped the challenges into four categories: (i) enterprises, competition, and the investment climate; (ii) infrastructure and regulation; (iii) WTO accession and trade; and (iv) social protection and pension reform. It is urgent to get on with them if the next phase of reform is to be as successful in raising living standards as earlier phases. Within each of these categories, there are many institutional possibilities, and China, as in the past, will choose its own approach, innovating along the way.

The fundamental principle in the new phase of reform is the shift from the government being the "parent" protecting and improving the firms to the government as establishing an enabling framework so that competition will be the driver to improve firms—while protecting and helping

the people who need to readjust to the new environment. All else I have said follows from that challenge.

The next years in China will be years of real promise. They will be challenging as the reform process develops and adapts through the next phase. With great anticipation, I look forward to discussing policies and strategies with you all.

Thank you.