

CHAPTER 1

INTRODUCTION: POLICY REFORMS AS A PROCESS OF LEARNING

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The rapid growth in the Chinese economy despite the fact that its economic institutions and policies appear gravely inadequate against the propositions of mainstream economic theory has posed many puzzles to development economists. As pointed out by Summers (2007), in the past three decades, China has experienced the same degree of industrialization that took two centuries to occur in Europe. While many foreign observers frequently highlight the institutional constraints hindering China's development progress, it continues to have maintained record levels of economic growth and poverty reduction. The Chinese experience has been widely studied (Qian, 2003; Fan, Zhang, and Zhang, 2004; Hofman and Wu, 2007; Lin, 2007; Ravallion, 2007). For example, Lin (2007) argues that China's rapid growth is due to its shift in development strategy from capital intensive to labor intensive, in line with China's comparative advantage. However, there are still many myths and questions about the internal processes and logic that drove the reform. Most of the previous studies provide *ex post* assessment of the major reform measures, yet offer little insight into the internal, political processes of reform.

Many of the approaches used in the reform process are unorthodox from a standard neo-classical paradigm (Rodrik, 2004). It is possible that heterodox reform measures may be too China-specific to be transferable to other countries, but some of the policies and strategies behind the reform process may transcend international borders, and we believe in the potential of drawing out the lessons from China's development path for

the broader development community. The successes of these reforms may challenge traditional neo-classical economic theory, and the much debated Washington or post-Washington Consensus.

We follow a framework on the process of economic change developed by North (2005). He views development as arising from incremental steps by many decentralized agents which shape the formal rules and informal norms and hence the overall economies. Policy change entails uncertainty to human beings. People often have different interpretations of the uncertainty associated with proposed change, and each interest group has its own perceived payoffs and risks from proposed policy changes. In essence, reforms are ways to break the existing, less desirable equilibrium among different interest groups and move it to a more favorable one. Facing a binding constraint, there are potentially many solutions. Therefore, successful reform strategies help to enlarge the choice sets, reduce the perceived risks, and improve the understanding of potential payoffs of different policy options.

To understand how the reform process in China originated and why it succeeded, distinguished policymakers and researchers who were involved in the reform process present their textured and first-hand accounts of the reform process. This narrative approach provides a rich story about the reform processes and is instrumental in helping generate hypotheses which can be tested by quantitative methods. Several common themes emerge from the case studies. The key ingredients are summarized here, focusing on the use of crisis as an opportunity, experimentation with regionally-specific policy formulation and reform, sequencing, information flow and consultation, and institutional capacity in addressing barriers to reforms.

1.1. Use the Crisis as an Opportunity

Vested interest groups evaluate the risks and payoffs with regard to the consequence of proposed policy change. People often have different perceptions of the uncertainty related to change. Although crisis is bad by definition, it may help radically revise perceived risks and payoffs of certain policy options. A crisis can also redesign policy priorities where new approaches emerge out of previous failures, a process that we are

witnessing during 2008–2009 after the financial crisis, with a radical reorientation towards a more inward-oriented development model, and intense political discussion about the directions of these reforms. Despite the negative effects of any crisis, crises necessitate change and re-examinations of current policies. We use several examples in this book to illustrate how crisis may beget reform.

After the Cultural Revolution (1966–1976), China was on the verge of collapse under the planned economy system. More than two-thirds of people lived under one dollar per day (Ravallion, 2007). With stagnant agricultural growth and fast population growth, food was in short supply. At the onset of reform, it seemed China faced extremely high barriers to escaping the low-level equilibrium trap where poverty persisted. However, as shown in the chapter by Du Runsheng, one of the architects of China's rural reform, a crisis may trigger reforms. After the end of the Cultural Revolution, both the top leaders and masses realized that the planned system was not a viable option anymore and there was a consensus to change it. Under this circumstance, the top leaders were more willing to listen to different opinions and to allow open policy debate. In other words, crises may provide reformers with a window of opportunity to push their reform agenda. Reforms do not come automatically and require policymakers to seize this as an opportunity. Reform policies must be developed in a timely fashion after crises to be a legitimate alternative.

One noted example is the rural reform documented by Du, presented in Chapter 2 of this volume. Farmers who experienced the Great Famine in the late 1950s and early 1960s still had a vivid memory of the disaster and they knew the collective farming did not work in times of crises. So with another imminent weather shock looming in 1977, the local government in Fengyang County, Anhui Province, decided to contract the collective land to farmers because they knew the collective farming system could lead to another famine in the event of a severe shock. Yao (2007) provides an extensive review of land tenure changes in rural China. He argues that when the household responsibility system (HRS) was scaled up, despite some initial resistance, most farmers welcomed the reform measure wholeheartedly because they knew collective farming did not work.

China's village elections, described in Chapter 6 by Wang Zhenyao, are another notable example. Until the mid-1980s, both the head and party secretary of a village were appointed by the upper-level government. With the rapid abolition of people's communes, and the shift of production from collective farming to the household responsibility system in the late 1970s, the appointed leaders lost their political legitimacy. Many villages failed to provide basic public goods and services. The conflict between cadres and villagers over taxation became increasingly serious. Facing this pressure, the central government started to embrace the idea of grassroots elections, previously taboo, by giving local people a larger say in their local affairs. After several years of experimentation, the central government called for widespread implementation in the early 1990s.

The third example is the Wenzhou model, described by Zhu Kangdui in Chapter 5 of this volume. Wenzhou used to be one of the poorest regions in China. At the war frontier to Taiwan in the planned economic era, the central government had made little public investment in the region. Together with geographical isolation and high population/land ratio, many people fled elsewhere to escape starvation. Because they were so poor prior to reforms, Wenzhou people wanted to change to have a better life. The local government officials respected popular demand. They lobbied the central government to grant them permission to conduct policy experiments on rural industrialization in Wenzhou. They supported the grassroots reforms of vast number of entrepreneurs to overcome institutional barriers faced by private enterprises. At the time, it was illegal for a private enterprise to hire more than eight workers. In order to avoid direct conflicts with the legal system and to reduce the high transaction costs caused by branding, many private enterprises resorted to some makeshift practices such as attaching themselves to a legal enterprise or organization to avoid the ownership risk of hiring more than eight workers in a private firm. Local governments accepted these practices as well. In addition to allowing those "wearing red hats" (private firms registered as TVEs), the local government conducted many institutional reforms to create an enabling environment for private business. Not only have Wenzhou's reforms promoted its local economy, but they have also provided valuable experience for China as a whole.

1.2. Crossing the River by Touching the Stones

Having observed the disastrous performance of the ideology-based process in the planned economy era, such as the Great Famine (1959–1961) and the Cultural Revolution (1966–1976), in 1978 the Communist Party’s 11th Congress shifted the policymaking process from ideology-based to evidence-based under the slogan of “seeking truths from facts”. This approach places great weight on demonstrated evidence on the ground instead of on theory. The policymakers adopted a programmatic attitude toward reform (“crossing the river by touching the stones”). The success of the economic reform in the past 30 years triumphs the virtues of this incremental reform strategy. All the chapters in this book illustrate one of the distinguishing features of China’s reform experience — that economic success has been a process of gradual and sequential reforms, consciously avoiding “big-bang” approaches. Pragmatism, trial and error, and experimentation with small-scale policy reforms that are later scaled up are key features of China’s reforms.

Learning by experimentation is a key strategy in reforms, particularly when facing huge uncertainty. When facing choices never seen before, it is extremely risky for agents to make radical choices. In such circumstances, experimentation can be a useful tool to search for more information and test and update hypotheses. Experiments yield information to help understand what works and what does not work. Even failures can be helpful because they can help eliminate unfavorable options, as shown by Luo Xiaopeng’s case study (Chapter 3). The failure of his price reform experiment in Hebei Province helped him come up with the idea of dual-track price reform. Although this idea was dismissed by Murphy *et al.* (1992) as provoking drops in output in the Soviet Union due to increased arbitrage and corruption, the dual-track price reform is an important example of an experiment where the “Washington Consensus” wisdom was contradicted.

The multi-faceted fiscal and tax reforms described in Chapter 7 by Liu Zhongli and in Chapter 8 by Weng Lihua similarly show the gradual (and long-term) nature of successful reform. The fiscal reforms of the early reform phase contributed towards decentralization, but greatly reduced the national fiscal income. Reforms in the first half of the 1990s

involved a range of measures to allocate taxes between governments and state-owned enterprises (SOEs), creation of separate state and regional tax bureaus, and ways to link tax returns to regional economic growth rates — and as Liu Zhongli emphasizes, the optimization of resource allocation in the context of Chinese specific circumstances remains a challenge.

Moreover, experimentation can help control the possible disastrous consequence of wrong choices. A wrong choice, at large scale, may be irreversible, and therefore may undermine political stability and weaken the learning capacity. Most of the experiments presented in this book were not random. Most of the experiments started in isolated, poor areas. As shown in the chapter by Du, the leaders purposely situated the pilot experiment of the household responsibility reform in remote provinces to avoid negative spillovers and to reduce political resistance. One reason that Wenzhou received the special permission to be a pilot of rural industrialization was because of its rather isolated location at the time. Overall, most experiments were insulated from the wider society and economy. This means that in the event of failure, repercussions are contained. It should be noted that these experiments were not randomly designed as advocated by mainstream development economists (Duflo, 2005).

The experiments and demonstrations allow individuals to become acquainted with proposed changes, to reduce perceived risk and to better understand the possible payoffs. As vividly documented in Wang Zhenyao's case study (Chapter 6), China conducted numerous pilots of village elections before scaling up. When the idea of village elections was first put forward, it received strong resistance. Nonetheless, the central government encouraged some provinces to conduct pilot experiments. The success of these experiments helped reduce the perceived risks of village self-governance. This led the People's Congress to pass the implementation amendments to the Organic Law in 1992.

Similar to the pilot stage, in the implementation stage too many counties followed a two-step process. First, the county civil affairs bureau selected several townships for the village elections experiment. In the second step, the county civil affairs bureau analyzed and summarized the experience from pilot experiments, adjusted election rules, and then encouraged countywide elections. Throughout the whole process, the civil

affairs bureau organized many meetings to facilitate the exchange of experiences and lessons. The descriptions of fiscal reforms in Chapters 7 and 8 similarly highlight the consultative nature of reforms, and in the case of Zhejiang Province the space for regional differences in policy implementation.

The post-Mao era in China adopted an evidence-based policymaking process. Most successful reforms have undergone pilot experiments and impact evaluations before being scaled up. Although the experiments were not rigorously and scientifically conducted by including control groups, the pilots enabled researchers to observe what worked and what did not on the ground.

1.3. Right Sequencing is Crucial

One of the lessons from the Chinese reform experience is the right sequence of reform policies. Beginning with agriculture ensured that the majority of the population benefited from the initial reforms (for example, the increase in the procurement price), given the overwhelming dependence of the population on the primary sector. The large number of prospective beneficiaries also helped generate consensus and create political support for the subsequent stages of the reform process. The various incentive reforms — including the new land tenure laws, the rise in procurement prices, marketing reforms, and exchange rate interventions — led to an improvement in returns for farmers and in the efficiency of resource allocation in the economy. As a result, the domestic production base was strengthened and gradually made more competitive.

Integration into the world market through trade liberalization was attempted only *after* these land, price and other reforms were successfully implemented. The success of the early agriculture-led reforms also increased the demand for non-agricultural goods and released a surplus of labor and capital into the rural non-farm sector. As the rural non-farm economy thrived, it provided farmers and rural areas with an additional investment source outside agriculture and its allied sectors, and it put pressure on the urban economy to reform as well, since non-farm enterprises in rural areas became more competitive than SOEs. These

successes triggered macroeconomic reforms and also favored the opening up of the economy and the adoption of measures such as the special economic zones to increase foreign investment.

1.4. Information Biases

For policymakers to make evidence-based decisions, it is key to have information on the payoffs and risks of different policy options. While a large population like China's is likely to produce many good ideas and solutions to problems, its size also makes it more difficult to aggregate the scattered ideas and feed them back to the policymakers. In a non-democratic society, the problem of asymmetric information may be particularly serious.

Due to China's vast size and uniquely centralized governance structure, there is a huge information asymmetry between the top policymakers and people on the ground. The case studies illustrate different ways to reduce the information asymmetry. First of all, it is important that policymakers at the top realize that they are likely to be subject to information bias (as in the "emperor's new clothes"). In China's case, as documented by Dr. Luo, after the Cultural Revolution, the top leaders were extremely willing to look for the best ideas on the ground. Due to lack of other communication channels, think tanks (such as the Rural Development Research Center led by Mr. Du) played a key role in the initial reform period by searching for best practices, piloting policy experiments, and analyzing and feeding recommendations back to the Chinese leadership. At the time, there was also an atmosphere of tolerating different views. The leadership had de-politicized collective learning, as described in Chapter 3 by Luo Xiaopeng. This open debate in the now famous Moganshan Conference in 1984 stimulated the invention of the idea of the dual-track pricing. Facing large uncertainties in policy reform, open policy discussions can play a key role in expanding the choice set and increasing the likelihood of finding best solutions.

Secondly, for a large country such as China, each region may face different binding constraints, and it is hard to come up with a one-size-fits-all strategy. Under this circumstance, giving local governments freedom to explore the best solutions to their local binding constraints becomes crucially important in innovations. As shown in Zhu Kangdui's case

study, the success of the Wenzhou model of industrial privatization lies largely in its continuous experimentation and innovations which were implicitly supported or at least not opposed by the central government. In the formulation of migration policies, as described by Professor Cai Fang in Chapter 4, the central government encouraged local governments to try different reform measures. One virtue of China's vast size is that, as long as experimentation is allowed, the chance of finding a best solution to challenging problems is quite high. Moreover, the best practice has strong externalities. Not only does it have a huge demonstration effect for other regions, but it can also be scaled up. Both the Wenzhou model and village election case studies highlight this point.

1.5. Reducing Resistance to Reform

Even if a good reform measure has been identified, reformers still need an effective strategy to reduce political resistance. Faced with a planned reform, some vested interest groups may perceive a loss as a result of it. A successful reform strategy should try to reduce opponents' perceived risks and protect their interests, at least in the short run.

Take the household responsibility system (HRS) as an example. Its principle is that individual households can claim the balance after fulfilling the grain quota to both the state and collective units. Under this arrangement, the rent claim rights on agriculture products belong to peasants. The key condition is that farmers must meet the compulsory quota to the state before selling the extra production to the market. Because peasants could possess the entire balance after fulfilling the state quota, their enthusiasm for production dramatically increased. The improved incentive system immediately resulted in the full utilization of the long-term investments by the state in agricultural research and development, irrigation, and other infrastructure.

While with hindsight it is clear that the design of the HRS was a great success, most province governors opposed it in the beginning, on ideological grounds. As a response, the reformers proposed to conduct the HRS pilots in the most remote provinces. In doing so, either the success or failure of the pilots would not affect other richer provinces which perceived higher risk in the HRS. Most governors agreed with the idea of pilots in remote provinces. In the next year, the pilots showed powerfully

that the HRS greatly improved agricultural productivity while its risk was minimal. With the new information on payoffs and risks, almost all the provincial governors reversed their opposition in favor of the HRS in the next year. The HRS was quickly scaled up nationwide.

Prior to reform, in the hierarchical property right and entitlement system, urban sectors, particularly SOEs under the control of the central, provincial, and municipal governments, enjoyed privileged access to a variety of scarce materials and capital goods through quotas. There were few quotas, however, for other lower-level SOEs and even fewer for collectively-owned enterprises. The dual pricing system, as described by Luo Xiaopeng, allowed SOEs to sell unused input quota at market price to township and village enterprises (TVEs) which were outside the command economy. Such exchanges not only protected the original privileges of higher ranking entitlements, but also presented TVEs with opportunities to access industrial inputs via market channels and to participate in the market economy. In other words, the dual pricing system provided a functional pricing mechanism for rent sharing through both hierarchical and market systems. Because the dual-price reform initially did not have a negative impact on the SOEs' entitled planned quota, resistance to the reform was muted. Over time, as the private sector grew rapidly and the market price and planned price converged, the dual-track was eventually unified into a single-track or market price.

1.6. Institutions and Capacity

Finally, any reform must be built upon existing institutions and capacity. It is hard to establish new institutions from scratch. Local people usually have much better tacit knowledge on the strengths and weaknesses of their own institutions. Therefore, they are more likely to have better ideas to engineer institutional change than an outsider. No doubt, the knowledge stock from the outside world is extremely useful — but the key is how to facilitate the exchange between external knowledge and indigenous knowledge to solve local problems. Having the capacity to learn and adapt to changing environments is an essential condition for the success of any reform. Undoubtedly, China has a rather strong top-down governmental structure. Once a decision is made, the speed of implementation is much

faster than in many democratic countries. International observers have been struck by the efficiency which with China “gets things done”, once priorities are recognized. For example, policies on agricultural development, rural industrialization, migration, the control of SARS, HIV/AIDS prevention and harm reduction, and currently the responses to the 2008–2009 financial crisis have been rapidly implemented at the local level.

The top leadership’s commitment to reform also played a key role in pushing reform forward. In particular, Mr. Deng Xiaoping advocated a pragmatic approach for reform by relying on empirical evidence and experience on the ground rather than on dogmatic beliefs from textbooks. It was the top leaders who granted wide space for local governments to experiment. Zhejiang Province’s bold experiment of abolishing rural taxation proved that the benefits of the reform far outweighed the costs. As a result, this policy was quickly scaled up (Chapter 8). Certainly, the strength of civil service ensured the implementation of various reforms (Ravallion, 2007).

Cai Fang’s case study on migration policy (Chapter 4) shows the importance of adaptive efficiency and tacit knowledge. In the planned economic era, China implemented a strict migration policy, the so-called *Hukou* (household registration system), restricting people to their natal places. The government was afraid that a sudden abolishment of the *Hukou* system could lead to massive inflows to cities and create slums. With this concern, governments took a gradual approach to lessen the control on human mobility. Initially, it allowed farmers to go to cities to sell agricultural products, such as vegetables and fruits. Next, the food coupon, which permitted one to purchase grain and other food products from certain locations, was abolished so that people could buy grain at the market price anywhere. This enabled many farmers to live in cities. In response to the death of a college student who was beaten to death for lacking an identification card in Guangzhou, the central government passed a law to prohibit law enforcement from checking people’s ID and other paperwork on the street. This made migration much easier than before. As more and more rural people work in the cities, urban residents are gradually finding that they cannot live without the necessary services provided by the rural people. Recently, many local governments have abolished the *Hukou* system, and since the last National

Party Congress migrant workers have become represented in national politics.

Thus, the case studies in this volume show that learning by experimentation is a key feature of China's reform process. While there is justifiably a lot of excitement about what China has achieved, the success has also created a range of problems such as access to healthcare and basic education in the countryside, the environmental costs of development policies, and groundwater pollution in agriculture.

As China has accumulated huge foreign reserves and fiscal revenues, policymakers may become overconfident about their contribution to the economy's success. The recent policy debates indeed show an increasing confidence, and China seems to be among the few countries able to manage the current financial crisis even though growth rates have dropped greatly in China too. Under this complacency, one is more likely to make centralized decisions, neglecting the wisdom from local levels and the virtues of experimentation. The reform stories presented in this book highlight the virtue of pragmatism and experimentation in the reform process. To overcome emerging challenges, it is important that policy-makers continue to focus on innovations from local levels with a pragmatic attitude.

1.7. Are There Lessons for Other Countries?

Leaders from developing countries, notably Africa, have shown great interest in China's economic success and record of poverty reduction. Development scholars have noted that China's rise challenges the fundamentals of development theory. We return to this question in the last chapter of this volume, with a review of the growing literature on the subject and a consideration of the way in which policy learning occurs.

In conclusion to this introduction, we highlight that such lessons for others are not easily drawn. This is not only because the context of China is so different from that of most other countries. The key to China's success and ways in which it addresses emerging challenges is clearly the pragmatism and understanding that solutions need to be based in local contexts, combined with a political drive to promote reforms and the space given — by necessity or otherwise — to local experimentation.

The international community is gradually moving away from an understanding that China's reforms are still "partial", to a better empirical understanding of how the reforms took place, how and why they were initiated, and what successes and challenges emerged as a result. We hope that the contributions in this volume make a modest contribution to understanding China's development path, and thus also enrich the global development debate.

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