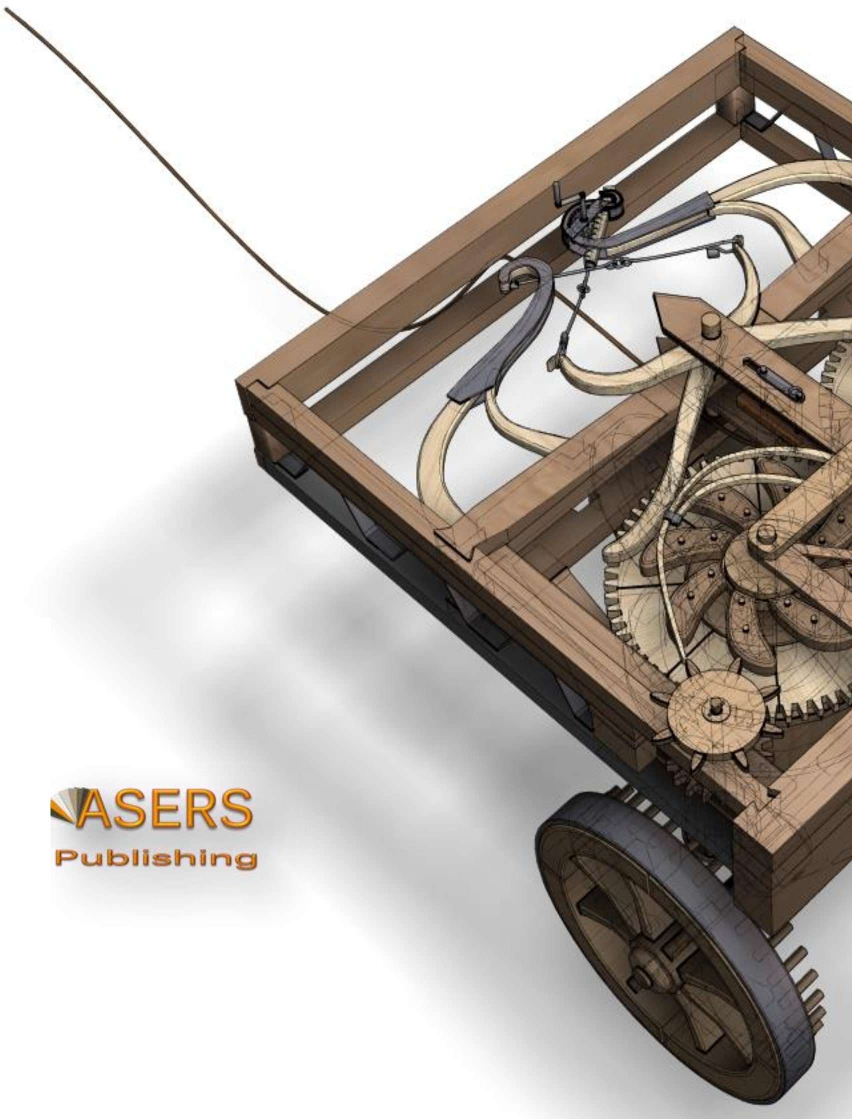
Theoretical and Practical Research in Economic Fields



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Theoretical and Practical Research in Economic Fields

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The Process of Economic Transition from Central Planning to a Market Economy: The Former Soviet Union Countries vs China

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Abstract: *This paper discusses the starting economic, social and political conditions of market-oriented reforms in the former Soviet Union countries and Eastern Europe and compares those to China. In addition, the pace of reforms and their sequencing, as well as their economic and political determinants, are also analyzed. The chapter then proceeds to evaluate the results of reforms in economic and social terms and compares and contrasts the current economic systems in China and in the successor countries of the former USSR. Finally, differences between successor countries of the former USSR in their reform strategies and outcomes are also pointed out, concluding with the forthcoming economic and social challenges in China and successor countries of the former USSR.*

Keywords: economic transition experience; former Soviet Union; Eastern Europe; China.

JEL Classification: P27; P51; P52.

Introduction

This paper discusses the starting economic, social and political conditions of market-oriented reforms in the former Soviet Union countries and Eastern Europe and compares those to China. This is an important novelty, as this distinction is rarely pointed out in the literature and is thus emphasized here. In addition, the pace of reforms and their sequencing, as well as their economic and political determinants, are also analyzed from a contemporary perspective, thus providing an opportunity for more recent re-evaluation of past events. The paper then proceeds to evaluate the results of reforms in economic and social terms and compares and contrasts the current economic systems in China and in the successor countries of the former USSR. Finally, differences between successor countries of the former USSR in their reform strategies and outcomes are also pointed out, concluding with the forthcoming economic and social challenges in China and successor countries of the former USSR.

The Process of Economic Transition from Central Planning to a Market Economy. USSR vs China

The process of transition, or transformation-, from central planning to a market economy in the countries of Central and Eastern Europe and former Soviet Union (CEE/fSU) started in the 1980-90s. However, around that time, the two groups - China and CEE/fSU countries - were at different stages of development: Russia was already semi-developed, with well-developed education and healthcare system, and social security programs. More specifically, Russia started centrally planning after WWI: The initial plan (1918-21) failed, and caused famine, and massive resistance of peasants. Next, the New Economic Plan (NEP) introduced some market principles in agriculture and enterprise management, but Stalin's collectivization undid those positive effect: there were shortages, in some sectors, budget constrains were soft, and subsidies were extended to cover losses. In turn, that led to perverse incentives, and managers were always asking for subsidies. In addition, the collective property rights were bad for investment, and led to thefts and mismanagement. Overall, the system was not sustainable, and had to move to democracy, market-based economy, and macroeconomic equilibrium.

Furthermore, hard budget constraints had to be implemented, and prudent policies to be put in place, such as price liberalization, opening to trade, targeted welfare system, and privatization.

In contrast, China had a different experience before 1980s. China was in decline in the 30s, then Mao's collectivization policies (1958-59) led to another collapse; the cultural revolution 1966-71 was also devastating for the economy. After Mao's death, Deng Xiao Ping initiated a series of reforms in 1978: the household responsibility system, de-collectivization, dissolution of communes, turning land to private hands, and implementing dual pricing – which meant that some of the output was sold at pre-set prices, while the rest was sold on the market. This was very important, as agricultural output constituted more than 50% of the Chinese GDP. So, China had only started to industrialize in 1990, while Russia was already over-industrialized. Another stark contrast to Russia was that China had a labor reserve in rural areas, while this process has already been exhausted in Russia.

In addition, China kept its institutions during the process of transition, which added to the credibility of the economic reforms. On the other hand, there were no large political changes, as the Chinese Communist Party was very much against any major democratic reforms. In some way they were maybe right, as the democratic regime was viewed as weakening of the state. In hindsight, however, Stiglitz's advice to CEE/fSU countries in the 1990s to follow the Chinese gradualism approach was not correct, as China had a shock collectivization and industrialization earlier, which required radical de-collectivization later. As pointed by by Dabrowski (2014), there were 3 major differences in initial conditions: (1) the level of economic development and industrialization at the beginning of the transition; (2) social policy and social services, and (3) the difference in political environment. We will discuss each in turn.

At the start of the transition period 1989-91, most of the CEE/fSU countries had 20-50 times higher GDP per capita (in PPP constant $) than China in 1980, when the transition in China started (Dabrowski 2014, WDI 2023). The CEE/fSU countries were already middle-income countries, while China was lagging behind. Even in 1990, after 10 years of Chinese transition, China is significantly behind even the worst FSU/CEE country, and one-tenth that of Russia (Dabrowski, 2014). In terms of the structure of the industry, the state-owned industry was non-competitive in both China and CEE/fSU, but China was under industrialized, while CEE/fSU countries was already over-industrialized. Another important difference was that the latter were also overmilitarized: China's military spending was a mere 2.7 % of GDP, relative to that in Russia (17.5%), Romania (4.8%), Hungary (3.1%), Poland (1.9%), as quoted in Dabrowski (2014). Of course, that spending was at the expense of consumption and investment goods. The difference becomes even larger when one controls for the size of each country.

That was because in 1980, agriculture (based on manual labor) made the majority of Chinese GDP, while in CEE/fSU countries that was manufacturing, and agriculture was largely mechanized, but not effective, and very energy intensive. This higher energy intensity was just one of the examples of higher distortions present in CEE/fSU countries, as compared to China. Chinese labor productivity was low, but once the food supply for the nation has been secured, there was an army of labor that could be redirected to the urban areas, where the new plants were being built. In contrast, CEE/fSU countries were operating at zero unemployment, and enterprises were overstaffed; CEE/fSU countries were industrialized, but also collective. That made industry unproductive, and often the value of output was less than the value of inputs. It was then not a surprise that output declined in the initial years of transition, as those countries had to downsize, and lay off workers, who remained unemployed ever after. There was also use of old machinery, the plan did not account for replacement parts, for amortization, and that deliveries of spare parts did not arrive on time.

In contrast, China in the 1980s had already dissolved the communes, and Chinese agriculture was already private. This is very important, as private ownership utilizes the profit motive, and productivity improvement considerations, which are central in achieving economic growth. Thus, agricultural output in China increases (while it was collapsing in CEE/fSU), while there was less need for labor/employment, which led to the release of this surplus labor to urban areas. China used the surplus labor from agriculture for manufacturing, together with the high savings that were channeled into capital investment in the manufacturing sector. Such a self-financed model was not available in Europe, where CEE/fSU had to borrow/privatize to obtain modern capital in manufacturing. In addition, in China, it was easy to start a business initiative, mostly through a quasi-market arrangement (town enterprises), where the town set up an enterprise, but then left to the people to manage it in a market environment, based on market principles.

Another major difference between CEE/fSU countries and China was the huge differences in social policy and the provision of public goods. In China only public employees, or 20% of population, were eligible for a pension. This was also the case in CEE/fSU before the Communist regime took over, which forced a move towards a solidarity model, *e.g.*, a universal old-age pension has been in place since the 1950s. Same held for universal health insurance, and universal unemployment insurance, injury-at-work insurance, maternity leave, etc.

In other words, CEE/fSU countries had a social safety net that was very similar to that in Western Europe. However, when the state was doing the saving for the population, private saving rate decreased a lot. In contrast, China had a very high private saving rate, which was then used to finance the investment rate for the industrialization stage. In addition, the burden of social expenditure in China was low, while it was and too high in CEE. In addition, there was no or low social regulation in China. Lastly, health and education services in China were also poor.

On the political front, there were also major differences between CEE/fSU countries and China. In particular, in the last years of communism central governments in CEE/fSU were not able to use coercive force - overall, the command system was collapsing, there was widespread lack of discipline, theft, central plans were becoming quite unrealistic, managers were cooking the books, etc. In contrast, China was able to keep selectively certain parts of the command system (a planning bureau still exists to this day). In addition, the Chine Communist party is still the monopoly party in China, while in CEE/fSU countries the regime collapsed, and brought democracy. Overall, there was much higher demand for democratization, relative to China, where a potential democratic revolution in 1989 was suppressed by force by the Communist party. Those completely different political environments also determined the differences in the transition experiences of China vs CEE/fSU.

In CEE/FSU countries there was still need for unpopular structural reform – they had to cut spending, which was always resisted. There was also over-staffing in public enterprises, where the high wage bill at the expense of modern machines in hospitals and lack of PCs in schools. In addition, there was a demographic crisis, as many left once borders were open, while among those who remained, many were unwilling to have children during times of uncertainty. In addition, there was a huge economic cost of de-collectivization and restitution of land rights to previous private owners. Plot sizes were small to justify tractor purchase, neighbors did not trust one another to enter a new collective and buy jointly a tractor to be used by the whole village. There were no such problems in China.

Next, the CEE/fSU countries had to secure macroeconomic stability – again, it was easy for China, as there was no social contract, and no obligation for solidarity model implementation. On the other hand, building a market economy was not the option under the authoritarian regime; instead, planning offices were using complex math models to avoid the use of prices, or use “shadow” or administrative prices.

In China, the market model was introduced despite the presence of a Communist party, and at the cost of repression. Overall, gradualism worked for China, but was not an option (or was less promising in the “best scenario”) for FSE due to government’s inability of fine tuning – with the quick change of governments, with policy reversals (*e.g.*, in Bulgaria during the first years), with the lack of basic public goods like electricity (power cuts), bread, and toiletries. Due to the lack of petrol, governments could not provide law and order, there were bandits and racketeers, as well as mafia-like structures in the underworld. In addition, gradualism was the platform of market socialist parties, which were “reformed communists,” or the third way – which ended up being a disappointing experience generally, as there was no clear path of reforms. The other, a radical approach (“shock therapy,” or “cold turkey”) called for comprehensive reform and irreversible move to a market economy. Indeed, 20 years after the transition started, fast reformers did better than gradualists: early reformers recovered the initial output loss earlier, implemented important structural reforms, liberalized prices and achieved macroeconomic equilibrium faster.

The Chinese experience was different, though. China went for very gradual reforms, with experiments at regional level, *e.g.*, the special economic zones that were established in the West regions, which attracted foreign direct investment, at the expense of the rural East which remained underdeveloped. This regional disparity is still present nowadays, while in CEE/fSU countries income distribution is much more equitable, and the prevalence of poverty is lower. In addition, China introduced dual pricing regime, under which enterprises also could send some output on market-based principles. This was until 84, followed by stage II of reforms (84-93), which included decentralization, regional leadership, regional market experiments. One such experiment was the township and village enterprises, where municipalities creating enterprises, but very quickly became quasi-private. Next, during 1993-05, China unified its exchange rate, introduced current account convertibility, liberalized trade, joined WTO, and implemented large-scale privatization of industry and financial sector. By 2005, it was an emerging economy, integrated with the rest of the world. However, it still had some capital controls, and also continues to subsidize the state banks and state enterprises. Furthermore, the relative laxity of fiscal and monetary policy led to the credit and real estate bubble. In addition, there was a public investment boom as a response to the recent financial crisis, which was a government policy to boost aggregate demand. As a result, investment in China reached 50% of GDP, and led to a lot of irrational projects being pursued and resulted in a lot of toxic assets in the financial system. Also, for a long time the world community protested against the intentionally underapppreciated Chinese currency renminbi (RMB), which allowed China to accumulate international reserves, which were invested in the US treasuries, and additionally fueled the crisis in the US in 2008.

The weak currency, and the low labor costs are behind the export led strategy followed by China, which is now the biggest world manufacturing exporter, and also due to the current-account surpluses – the biggest world creditor. As of 2010, more than 70% of Chinese GDP is from the private sector, and poverty has been massively reduced since the 1990s. Overall, macro equilibrium is achieved, but social programs are largely missing. In addition, the development of a middle class leads to an increase in labor costs, and the appreciation of the renminbi puts a break on export growth. In urban areas there is lack of space, which leads to spread of diseases (like with COVID-19), and air pollution is a problem due to the dirty production methods used in manufacturing. Lastly, there are problems with human rights (recent unrest in Hong Kong and Taiwan), the demographic crisis due to one child policy (which was recently abolished) – all put a break on extensive growth, growth rates start to decrease, and there are no more labor reserves.

By 2000, the transition was largely completed, with the majority of output (60-80% GDP) being produced in the private sector in most of the countries. [Notable exception are Uzbekistan (45%), Turkmenistan (25%), and Belarus (20 %).] Most of those countries are open for trade and financial flows. Still, some market distortions still persist, and there are governance issues with the rule of law and the quality of the institutions, namely non-banking financial sector, infrastructure, competition policies, enterprise restructuring, and enforcement of property rights. Overall, fast (early) reformers outperform gradualists, and early reformers recovered faster from the initial output drop in the 1990s. Next, sequencing, timing and pacing of reforms were crucial: macro-stability was achieved fast, while liberalization can be gradual. Inflation was put under control, thanks to the prudent fiscal policy has been put in place, and the implementation of hard budget constraints, rapid and *en masse* privatization, deregulations for new firms, restitution of land. Externally, the Balance-of-Payments was put under control, often with the help of the stabilization programs of IMF, structural loans from World Bank, accession to WTO. The EU accession brought economic growth through trade integration. All those were complemented by the global boom until the financial crisis (2008-10), and there has been a delayed recovery afterwards, which showed the need for more integration, improve business climate and governance. At the same time, targeted welfare programs need to be in place to support the socially weak layers of the population. To this day, West Balkans and CIS countries are still problematic, as well as Ukraine and Belarus. Russia has regressed substantially, due to the volatile oil prices, and the inflationary pressures. As a group, the CEE/fSU counties have increase in importance, but their total output still makes less than 10 percent of global GDP, and 3 % is due to Russian oil, followed by Poland with 2.9% (Dabrowski 2014). Only time will tell if this trend will continue in the future.

Conclusions and Further Research

This paper aimed to reignite the discussion on the starting economic, social and political conditions of market-oriented reforms in the former Soviet Union countries and Eastern Europe in comparison to those in China. This is an important contribution, as this distinction in the stage of development is rarely pointed out in the literature, and was thus particularly emphasized here. In addition, the pace of reforms and their sequencing, as well as their economic and political determinants, were also analyzed from a contemporary perspective, giving the readers another opportunity to re-evaluate and reflect on those past events. The paper then proceeded to assess the results of reforms in economic and social terms and compared and contrasted the current economic systems in China and in the successor countries of the former USSR. Finally, differences between successor countries of the former USSR in their reform strategies and outcomes were also pointed out, concluding with the forthcoming economic and social challenges in China and successor countries of the former USSR. Clearly, there is much need for further research work to be done on those issues.

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Credit Authorship Contribution Statement

Aleksandar Vasilev: Conceptualization, Investigation, Methodology, Project administration, Writing – original draft, review and editing.

Declaration of Competing Interest

The authors declare that they have no known competing financial interests or personal relationships that could have appeared to influence the work reported in this paper.

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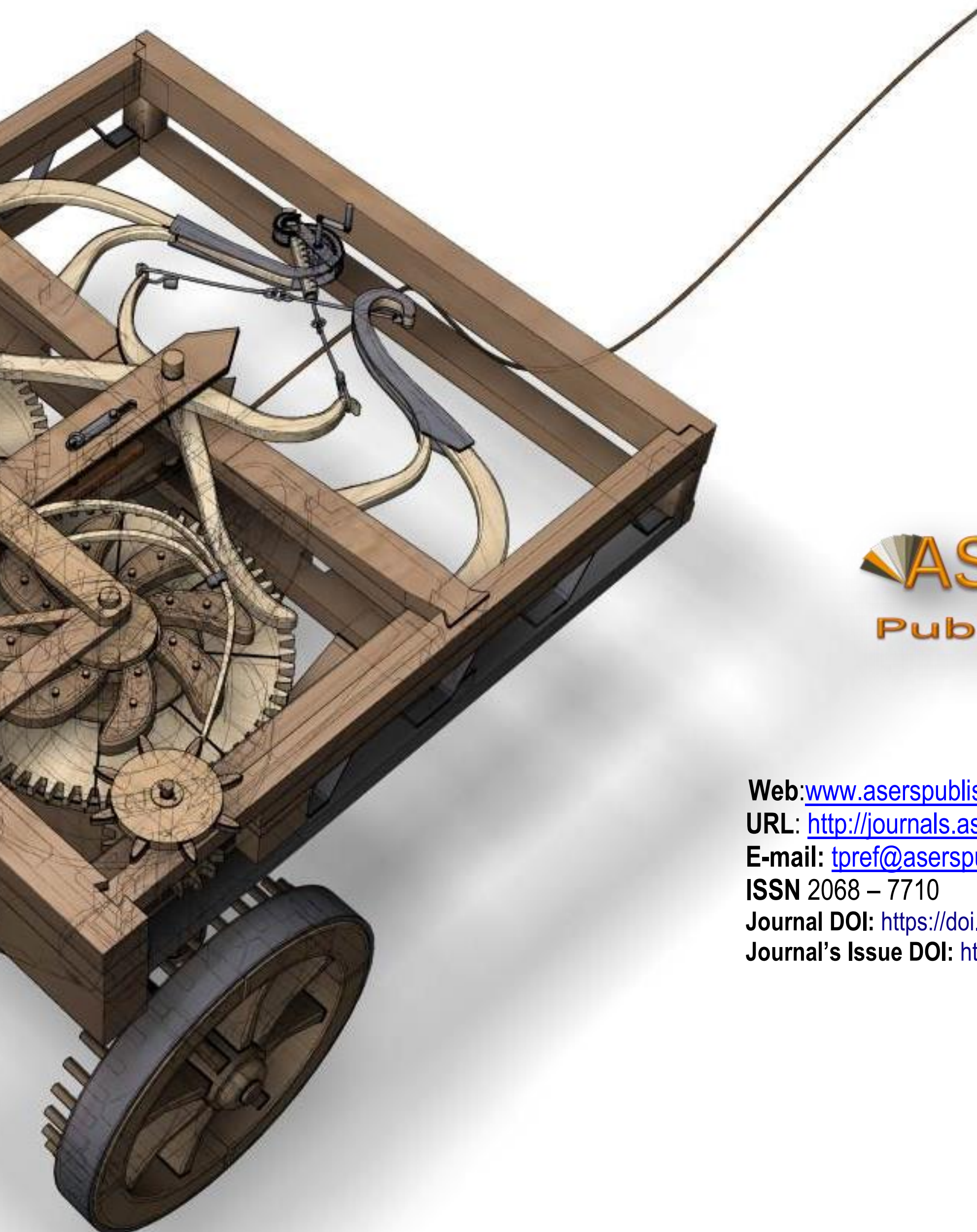

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