

China's Post-1978 Economic Development and Entry into the Global Trading System

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By **James A. Dorn**

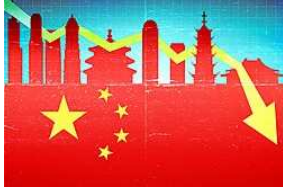
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- ◆ From 1978 and for three decades afterward, China moved from central planning and autarky to a market-oriented economy. Despite recent backsliding, it remains the world's largest trading nation.
- ◆ The growth of the nonstate sector has been the driving force in China's development.
- ◆ Marketization and opening to the outside world—not industrial policy or protectionism—allowed China to make better use of its resources and widened the range of choices open to people.
- ◆ The post-1978 economic reform was a spontaneous, evolutionary process in which individuals lifted themselves out of poverty as opportunities for trade and entrepreneurship emerged.
- ◆ China's desire to enter the World Trade Organization (WTO), which was realized in December 2001, was instrumental in invigorating the nonstate sector and laying the foundation for

institutional reforms that increased competition and helped spur economic growth.

- ◆ Although China has greatly benefited from marketization and trade liberalization, the country still lacks a free market for ideas and a genuine rule of law to protect persons and property. Under Xi Jinping, there has been a rise in state power, putting a drag on development and freedom.

China's journey from central planning under Mao Zedong to market-led development under Deng Xiaoping and beyond is complex. Yet one thing is clear: China could not have become the world's second-largest economy without allowing the market to play a decisive role in allocating resources and without integrating itself into the global trading system.

This essay examines China's transition from plan to market, with emphasis on the pre-Xi era, especially the early reforms. It also carefully examines the spread of marketization in China using the marketization index developed by Fan Gang and others.

Finally, it shows that, in addition to internal reforms that widened the use of markets, China's rapid development was driven by its opening to the outside world. It met strict conditions for joining the WTO and benefited from globalization, as did its trading partners.

China had no blueprint for its spectacular development but found that moving from plan to market, and taking into account the principle of **comparative advantage**, was a win-win situation. Yet there are many weaknesses in China's institutional architecture, especially the Chinese Communist Party's (CCP's) monopoly on power, the lack of an independent judiciary, and the absence of a genuine rule of law to safeguard fundamental rights.

Without a free market for ideas and limited government, China could drift back toward planning and control, putting a drag on market-led development. This is already happening under the rule of Xi Jinping. Turning inward and embracing industrial policy to prop up state-owned enterprises (SOEs) poses serious risks to the spontaneous order, harmony,

and wealth creation that free markets and limited government would bring to society.

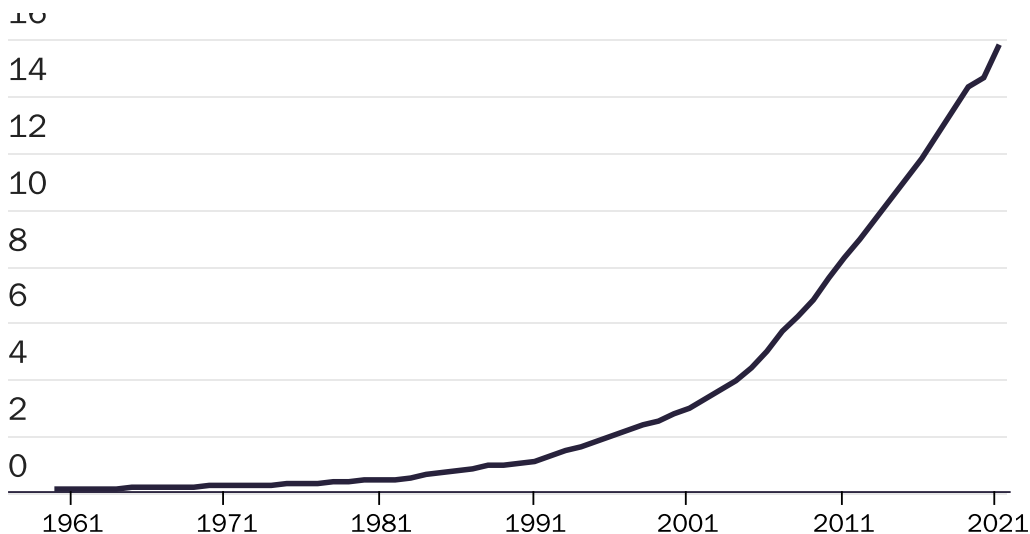
From Plan to Market: An Overview

China's rapid economic growth following its shift from state-led development (central planning) to marketization in 1978 and its drive to join the WTO are testaments to the idea that widening the range of choices open to people—via internal and external trade—is a winning strategy. Under Mao Zedong, protectionism and top-down planning led to a focus on developing heavy industry rather than improving people's lives by using the market price system to guide economic decisions. In 1970, Chinese real gross domestic product (GDP) stood at only \$232 billion (measured in 2015 U.S. dollars). However, once widespread marketization took place and individuals had more opportunities to get rich, real GDP grew to nearly \$16 trillion by 2019 (Figure 1).

Figure 1

China's shift from state-led development to marketization led to rapid economic growth

GDP, trillions of constant 2015 US dollars



Source: "GDP (Constant 2015 US\$)," World Bank, updated May 10, 2023.

Note: GDP = gross domestic product.

Getting the Relationship Right between the State and the Market

In 2015, Premier **Li Keqiang** argued that if China is to reach its full potential, it must "get the relationship right between the government and the market." He recognized that doing so would mean boosting the "vitality of [the] market." The political problem, however, is that allowing a greater scope for

the market means reducing the scope of government and diminishing the power of the CCP.

Markets are based on consent, not coercion. Under Mao Zedong, there was little freedom. Deng expanded freedom by allowing legal markets and nonstate enterprises to emerge along with more secure property rights. Today, China is far richer and freer than under Mao, but it is now turning back to some of the old ways under Xi Jinping.

Mao's Attack on Private Property and Free Markets

Under Mao Zedong, private property was outlawed, private entrepreneurs and landlords were treated as criminals, and Soviet-style central planning dominated economic life. In other words, the state monopolized the market.

China's second five-year plan, which launched Mao's Great Leap Forward (1958–1962), was designed to make China an industrial power. Instead, it destroyed agriculture and led to mass starvation as people's communes were established and resources were forcibly shifted from farming to heavy industry. In 1966, Mao initiated the "Cultural Revolution," a period of mass purges that lasted until his death in 1976.

During the Cultural Revolution, Red Guards randomly attacked anyone who might be seen as a "capitalist roader." Intellectuals were sent to the countryside along with all those who might pose a threat to the CCP's monopoly on power. Any deviation from party orthodoxy was deemed a thoughtcrime that could lead to imprisonment or worse. Children turned parents in to the thought police, and people were instructed to "strike hard against the slightest sign of private ownership," according to Jasper Becker in his book *The Chinese* (p. 157).

Deng Xiaoping's Quiet Revolution

The death of Mao in September 1976 paved the way for the rise of Deng Xiaoping as China's paramount leader in December 1978. Deng and his allies then began to open the door for a transition to a more market-oriented economic system. The CCP's primary focus became economic development rather than class struggle.

There was no blueprint for economic liberalization. As Cyril Zhiren Lin notes in *Remaking the Economic Institutions of Socialism: China and*

Eastern Europe (p. 100), "The most distinctive aspect of the Chinese reforms is that they have proceeded without a detailed reform blueprint.... The result has been a process of open-ended reform unique among the centrally planned economies."

Deng Xiaoping took a pragmatic approach to reform. If open markets could help improve life for the Chinese people, then it made sense to try that option—even in a socialist state. His mindset was that "it doesn't matter if a cat is black or white, as long as it catches mice."

Central planning could not be eliminated overnight. There would be no flag-waving revolution, only a quiet step-by-step movement from plan to market. Experimentation and innovation led the way to rural development, with the emergence of the household responsibility system and the creation of township and village enterprises (TVEs), which in the 1980s were an important component of the emerging private sector. The establishment of special economic zones (SEZs) in the coastal areas and the growth of the nonstate sector paved the way for China to become a major player in global trade. The entrepreneurial spirit of the Chinese people, which had been suppressed under Mao, came to life.

Marketization and Private-Sector Development

The impetus for marketization came from those who were harmed the most under Mao's disastrous policies—namely, people in rural households who had been forced into communes and suffered from the Great Famine. Some farmers began to contract with local authorities to gain rights to lease land from the collective and sell produce in private markets once official quotas were met. As the informal contracting system gained popularity, it was eventually sanctioned by officials. In 1982, Deng recognized the new institutional arrangement and labeled it "the household production responsibility system," as Kate Xiao Zhou notes in *How the Farmers Changed China: Power of the People* (pp. 3–4).

The essence of the household responsibility system, as Zhou points out in her book, is that it arose spontaneously as farmers sought to gain autonomy in their everyday life and improve their standard of living. When farmers became richer, they began to create TVEs. While some of the TVEs were associated with collectives, the most dynamic ones were de facto privately owned.

According to Zhou (p. 4):

The farmers took advantage of the corruptibility of the cadres rather than revolutionary action. Without anyone organizing a revolution, assuming leadership, or inventing an ideology, the farmers gained autonomy in farm planning, revived rural nonagricultural production, expanded old markets, and initiated new markets and migration to the city.... These spontaneous and apolitical efforts—rather than state ideology and in spite of Communist organization—formed the primary basis for China's current success in economic development.

The dramatic increase in the role of *private* TVEs, and the important part they played in spurring economic development in China, is clearly examined by **Yasheng Huang**. In 1978, at the beginning of the reform movement, there were no legally registered private TVEs, but by 1985, there were 10 million. Moreover, Huang notes that, in poorer provinces, "it was private entrepreneurship, not government-run township and village enterprises, that contributed to the bulk of output production."

Deng and other officials did not anticipate the success of TVEs. He remarked in *Fundamental Issues in Present-Day China* (p. 189):

They were like a new force that just came into being spontaneously.... If the central Committee made any contribution in this respect, it was only by laying down the correct policy of invigorating the domestic economy. The fact that this policy has had such a favorable result shows that we made a good decision. But this result was not anything that I or any of the other comrades had foreseen; it just came out of the blue.

Under the **dual-track price system**, planned and market prices existed side by side. However, as individuals "jumped into the sea of private enterprise," the nonstate sector grew and market pricing spread. In October 1987, the CCP approved **private enterprises** at its 13th Party Congress, and the following year, the Constitution of the People's Republic of China was amended to give private businesses legal status.

Growing Out of the Plan

Top-down privatization was not the path to marketization in China. Rather, as Barry Naughton points out in *Growing Out of the Plan: Chinese Economic Reform, 1978–1993* (pp. 8–9), China grew out of the plan by allowing development of the nonstate sector. In 1984, top officials agreed to keep planned output targets fixed along with resources allocated to the planned sector of the economy. Thus, as productivity in the market-

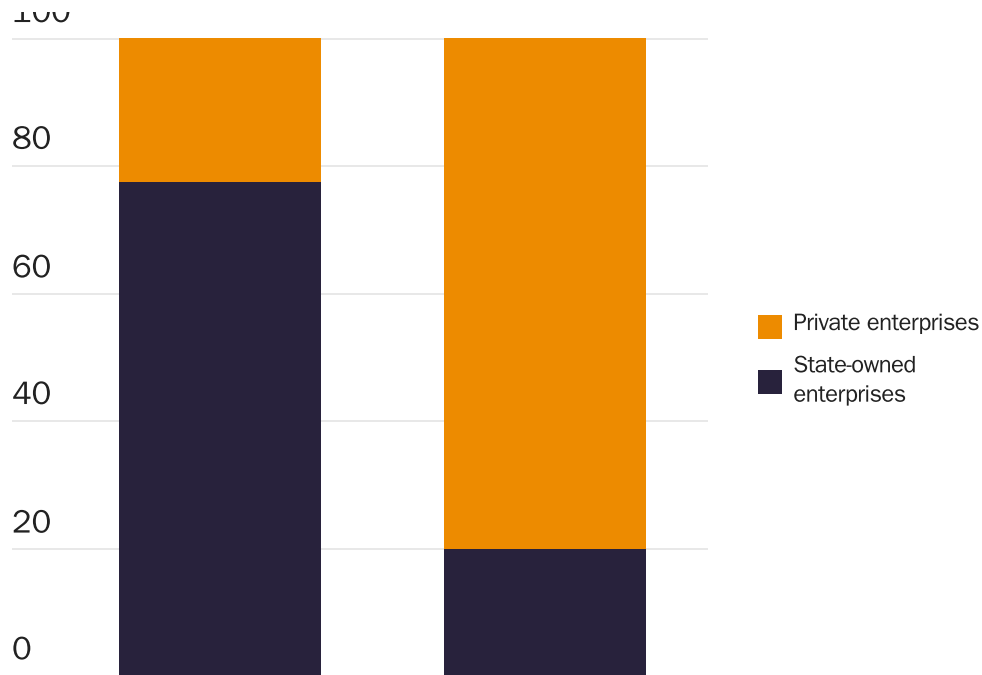
oriented sector grew, the contribution of the plan to national output declined. In effect, the dual-track price system was seen as transitory.

If we look solely at the industrial sector, it is striking that in 1978, SOEs accounted for nearly 80 percent of gross industrial output, but by 2016, their share had declined to 20 percent (Figure 2). In *China's 40 Years of Reform and Development: 1978–2018*, Nicholas Lardy attributed that relative change to “the opening of the economic space available to private firms, the superior financial performance of private firms and the increased access of these firms to funds from banks and the domestic stock markets.” However, he notes that SOEs continued to grow in absolute terms.

Figure 2

State-owned enterprises' share of Chinese gross industrial output declined sharply between the late 1970s and the mid-2010s

Share of Chinese gross industrial output, percent



Source: Nicholas Lardy, “Private Sector Development,” in Ross Garnaut, Ligang Song, and Cai Fang, eds., *China's 40 Years of Reform and Development: 1978–2018* (Acton, ACT: Australian National University Press, 2018), p. 333.

With rising inflation in 1988 and widespread discontent over corruption and the slow pace of political reform, mass protests erupted in Tiananmen Square during the spring of 1989. The authorities brutally ended the protests and placed Zhao Ziyang, a leading reformer and general secretary of the CCP, under house arrest. During his captivity, Zhao secretly recorded his memoirs, which were published abroad after his death. In *Prisoner of the State* (p. 270), he expressed what he could never say openly in China: “If a country wishes to modernize, not only should it implement a market economy, it must also adopt a parliamentary

democracy as its political system." That means allowing "other political parties and a free press to exist." He recognized that China needed a genuine rule of law if it was to establish a normal market economy.

After Tiananmen, the reform movement stalled, and economic growth slowed until 1992, when Deng took his famous southern tour of the SEZs, which he helped establish in the early 1980s. During his **visit to Shenzhen**, he stated:

We should be bolder than before in conducting reform and opening to the outside and have the courage to experiment. We must not act like women with bound feet. Once we are sure that something should be done, we should dare to experiment and break a new path. That is the important lesson to be learned from Shenzhen. If we don't have the pioneering spirit, if we're afraid to take risks, if we have no energy and drive, we cannot break a new path, a good path, or accomplish anything new.

Deng's main message on his tour was that "it doesn't matter if policies are labeled socialist or capitalist, so long as they foster development," according to Barry Naughton in ***The Chinese Economy: Transitions and Growth*** (p. 99). Of course, Deng and his comrades never intended to create what **Milton Friedman**, in his 1980 visit to China, called "free private markets." The goal of the CCP has been to create a system of market socialism, not market liberalism. As Deng reminded people on his southern tour, "It is essential to adhere to the principle of 'one central task and two basic points.'" Building socialism is the central task, while the two basic points are implementing "the policies of reform" and "opening to the outside world."

A Socialist Market Economy

Deng's message was repeated more than 20 years later at the Third Plenum of the CCP's 18th Central Committee in November 2013. In its **"Decision on Some Major Issues Concerning Comprehensively Deepening the Reform,"** the committee stated:

The overall goal of deepening the reform comprehensively is to improve and develop socialism with Chinese characteristics, and to promote the modernization of the national governance system and capacity. We must pay more attention to implementing systematic, integrated and coordinated reforms, promoting the development of [a] socialist market economy.

The committee advocated “centering on the decisive role of the market in allocating resources” and the importance of an “open economic system.” Accordingly, it held that

we must actively and in an orderly manner promote market-oriented reform in width and in depth, greatly reducing the government’s role in the direct allocation of resources, and promote resources allocation according to market rules, market prices and market competition.

Unfortunately, under Xi Jinping, China has **failed to carry out** the deepening of reforms and marketization goals of the Third Plenum. That should not be surprising, given the CCP’s adherence to socialist principles and its desire to maintain its monopoly on power.

The following passages from the ***Constitution of the People’s Republic of China*** make it clear that socialism remains the kingpin of the Chinese state:

Article 1: The socialist system is the basic system of the People’s Republic of China. Disruption of the socialist system by any organization or individual is prohibited.

Article 7: The State-owned economy, namely, the socialist economy under ownership by the whole people, is the leading force in the national economy. The State ensures the consolidation and growth of the State-owned economy.

Article 51: Citizens of the People’s Republic of China, in exercising their freedoms and rights, may not infringe upon the interests of the State, of society or of the collective, or upon the lawful freedoms and rights of other citizens.

Even though the constitution recognizes private property and other human rights, Article 51 makes it clear that fundamental human rights, which underpin a true market economy, are not inalienable, as they are under the U.S. Constitution. In China, all rights must be predicated to come from the **state if the CCP** is to retain its power and authority. In such a system, there will always be tension between state and market.

The Marketization Index

At the beginning of 1978, prior to the development of a market economy, most prices were still either guided or fixed by the state. However, by 1999, 95 percent of retail commodity prices, 83 percent of agricultural

commodity prices, and 86 percent of producer goods prices were set by the market, not the plan, according to Lardy in *Integrating China into the Global Economy* (pp. 24–25).

Although China has made significant progress toward moving from plan to market, much remains to be done. In particular, as **Wu Jinglian**, one of China's leading reformers, remarked in 2005 upon being honored for his role in China's marketization: "Only by matching the rule of law with the market economy can we achieve total success."

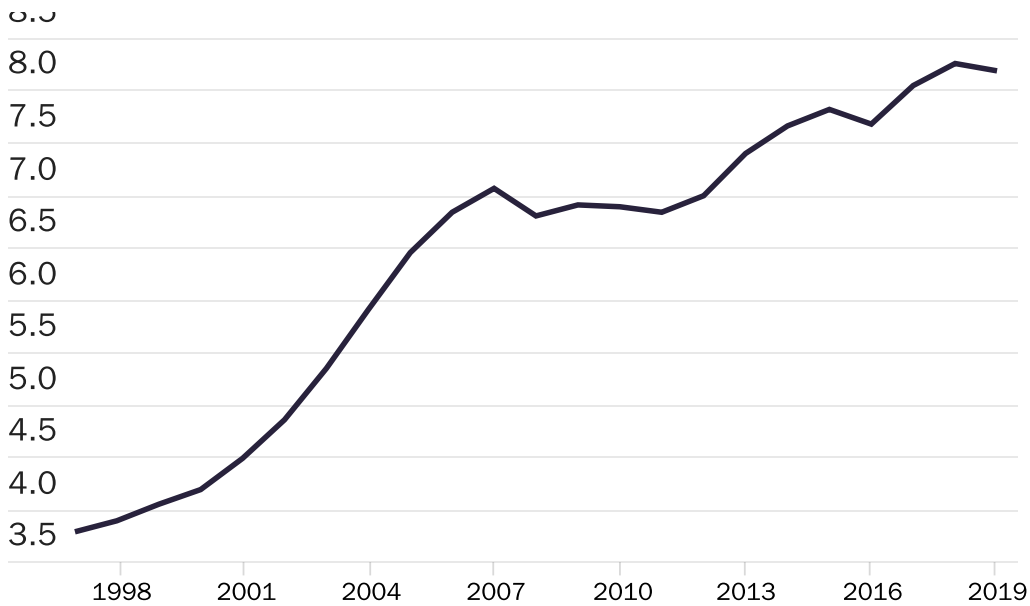
To measure the degree of marketization over time, the National Economic Research Institute has developed a **marketization index** based on five broad categories: (1) government-market relations; (2) development of the nonstate enterprise sector; (3) development of the commodity market; (4) development of factor markets; and (5) intermediate legal framework. Various indicators are then used to rank each of China's 31 provinces (including five autonomous regions and three municipalities under central administration). The province with the most progress toward marketization receives a score of 10, while the province with the least amount of marketization receives a 0. Coastal areas, such as Shanghai, Guangdong, and Zhejiang, are highly marketized relative to less-developed areas.

Figure 3 shows that the trend of marketization has been positive, with the *average* score for marketization going from 3.78 in 1997 to 4.48 in 2001 and 7.06 in 2007. The 2008 global financial crisis reduced progress on marketization, and the index did not exceed 7.06 until 2013. In 2019, the index stood slightly higher at 8.19. What this tells us is that on a number of fronts China has made significant steps toward a market-oriented economy. However, one should not view the National Economic Research Institute marketization index as telling us how close China is to achieving some ideal free-market system. Rather, it is a relative measure that gives us some idea of how well **marketization is progressing**.

Figure 3

China's economy has made significant progress toward moving from central planning to market orientation, though much remains to be done

NERI marketization index



Source: "Total Market Index," China Market Index Database, National Economic Research Institute (NERI).

In sum, since China's opening and reform movement began in 1978, there has been significant progress toward moving to a market-oriented economy. Marketization and economic growth went hand in hand. While China has developed a socialist market system, it has allowed a variety of nonstate ownership forms to evolve, including private enterprises, foreign-funded enterprises, and shareholding companies. Indeed, the private/nonstate sector has been the dynamic element in providing individuals with a chance to break the chains of poverty and become prosperous. In this sense, China has a soft socialism, not the hard state socialism that existed under Mao when private property and free markets were outlawed.

China's Accession to the WTO

While China developed its internal trade, it also began to open to the outside world. Under central planning, the state had a monopoly on trading rights. Only a handful of SOEs were awarded foreign trading rights. In effect, China was isolated from the international economy. However, beginning in 1980, SEZs were established in the coastal areas and given preferential treatment. In August 1980, SEZs were set up in Shenzhen, Zhuhai, Shantou, and Xiamen. From 1985 to 1990, those four SEZs saw the gross value of industrial output go from RMB 5.5 billion to RMB 49.5 billion. In May 1984, SEZs were established in 14 other coastal cities, including Shanghai, Wenzhou, and Guangzhou, according to Wu Jinglian in

The success of these open economic areas led policymakers to create many more zones to encourage marketization on an international level.

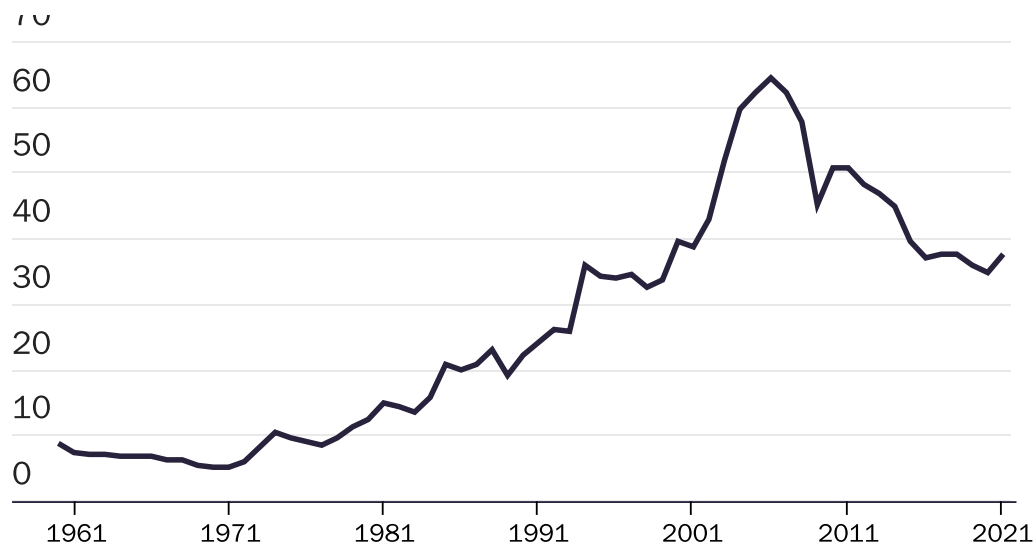
From Autarky to Engagement

Nonstate enterprises were the driving force in foreign trade. As trading rights were extended, the number of domestic firms engaged in foreign trade increased from 12 in 1978 to more than 5,000 a decade later. By 2001, when China joined the WTO, the number of domestic firms engaged in foreign trade reached 35,000, according to *Integrating China into the Global Economy* (p. 41). China's trade-to-GDP ratio climbed as tariffs and nontariff barriers declined in the run-up to joining the WTO. After accession, the general tariff level fell to 9.8 percent in 2007, compared with 16.4 percent in 2000, according to *China's 40 Years of Reform and Development: 1978–2018* (p. 35). Marketization reached new levels, and the foreign trade share of GDP accelerated (Figure 4). Today, China is the world's largest trading nation.

Figure 4

China's trade-to-GDP ratio rose as more nonstate enterprises engaged in foreign trade and trade barriers were lowered

Trade as a share of GDP, percent



Source: "Trade (% of GDP)," World Bank, updated May 10, 2023.

Note: GDP = gross domestic product.

Prior to joining the WTO, China unilaterally liberalized its **foreign-trade sector**. Domestic prices became more market oriented as firms were subject to foreign competition and the international price system. Resources were more efficiently allocated, and more open markets meant the Chinese people could benefit from both greater consumption opportunities as well as the exchange of knowledge.

Those benefits were a far cry from the autarky that existed during Mao's reign. Under central planning, the principle of comparative advantage was ignored in favor of imposing planners' preference for developing heavy industry at a **very high opportunity cost**. As Zhao Ziyang noted in *Prisoner of the State* (p. 137):

The result of doing everything ourselves was that we were not doing what we did best. We suffered tremendous losses because of this. I now realize more and more that if a nation is closed, is not integrated into the international market, or does not take advantage of international trade, then it will fall behind and modernization will be impossible.

It was China's opening to the outside world—not protectionism and industrial policy—that propelled economic development. As Lardy noted in *China's 40 Years of Reform and Development: 1978–2018* (pp. 335–36), it was only in 2003 that China formally established the State-Owned Assets Supervision and Administration Commission (SASAC) and tasked it with overseeing about 200 of China's largest firms and turning them into "national champions." In 2006, SASAC identified a number of "strategic and pillar industries" in the manufacturing sector and hoped industrial policy would spur their growth. However, success was limited: the SOE share of manufacturing output and investment fell, while that of private firms continued to increase. Thus, Lardy concluded that, although "the state has sought a more direct role in promoting economic development, it almost certainly should be judged a failure."

Premier Zhu Rongji supported China's accession to the WTO. His chief negotiator, Long Yongtu, **made a strong case** in July 2000 in the *People's Daily* for trade liberalization as a key force for China's future development:

Countries with planned economies have never been part of economic globalization. China's economy must become a market economy in order to become part of the global economic system, as well as the economic globalization process.

China's internal price liberalization and its relaxation of foreign trade restrictions, which began in the 1990s, paved the way for domestic prices of tradable goods to reflect global prices. Indeed, as early as 1992, "the domestic market prices of more than 95 percent of all imported goods were based on international prices," Lardy says in *Integrating China into the Global Economy* (p. 24).

Although much progress has been made in integrating China into the global economy, much remains to be done. The lack of an independent judiciary,

overreliance on SOEs (which are about 20 percent less productive than private-sector actors per the **International Monetary Fund**), financial repression, and abusive practices (such as cyberhacking into commercial networks and repression of free speech) threaten future progress.

China Needs a Free Market in Ideas

After more than 40 years of uneven opening up to the outside world, China still ranks near the bottom in terms of freedom of the press. In the **2023 World Press Freedom Index**, China ranks 179th out of 180 countries; only North Korea is lower. The value of free speech is that it allows people to improve institutions by pointing out weaknesses, which can then lead to improvements. As Eswar Prasad recognizes in ***Gaining Currency: The Rise of the Renminbi*** (p. 156), "Transparency of public institutions, the right to free expression, and an unfettered media are all necessary for building confidence. They do this not by emphasizing strengths, but by making weaknesses and faults in the system obvious."

The main lesson for China's future development is clear, according to Ronald Coase and Ning Wang in ***How China Became Capitalist*** (p. 207): "When the market for goods and the market for ideas are together in full swing, each supporting, augmenting and strengthening the other, human creativity and happiness stand the best chance to prevail."

Conclusion

Industrial policy and central planning under Mao Zedong proved to be a massive failure; they did not bring about sustainable economic growth or wide-spread prosperity. In 1978, Deng Xiaoping recognized the failure of state-led development and gradually reversed course in making the transition from plan to market, as Lardy in ***Markets Over Mao: The Rise of Private Business in China*** and Dorn in ***Economic Freedom and Prosperity: The Origins and Maintenance of Liberalization*** (chapter 9) point out.

The reform movement began with actions by farmers to gain rights to collectively owned land and to sell excess produce in the private markets. TVEs emerged spontaneously as farmers sought to increase their wealth by starting small businesses.

The foreign-trade sector expanded as China opened to the outside world and established SEZs in coastal areas. Nonstate enterprises, especially private firms, became the dynamic force in promoting economic growth.

While there was no blueprint for the household responsibility system or TVEs, the government had a more visible hand in the creation of SEZs.

China became an economic powerhouse by opening its markets, recognizing the nonstate sector, and allowing individuals to lift themselves out of poverty. Attempts at industrial policy under the SASAC failed. The lesson for China is to continue on the path of marketization and liberalization, not to revert to destructive state control and repression.

China can learn from its own history as well as from the West that economic and social harmony cannot be imposed from above. The challenge is to allow a free market for ideas as well as for trade in goods and services by institutional reform that protects both economic and personal freedom.

ABOUT THE AUTHOR



James A. Dorn

Senior Fellow Emeritus



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