# USING THE MARKET FOR SOCIAL DEVELOPMENT

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## Introduction

An episode during an earlier visit to China impressed me strongly with the wide gulf of understanding that separates people immersed in different economic institutions. That gulf makes it extremely important to stress over and over basic principles and ideas that all of us simply take for granted with respect to the system to which we are accustomed. The episode in question occurred when my wife and I had lunch with a deputy minister of one of the government departments who was shortly going to the United States to observe the American economy. Our host wanted help from us on whom to see.

His first question in that connection was, "Who in the United States is in charge of materials distribution?" That question took my wife and me aback. I doubt that any resident of the United States, however unsophisticated about economics, would even think of asking such a question. Yet it was entirely natural for a citizen of a command economy to ask such a question. He is accustomed to a situation in which somebody decides who gets what from whom, whether that be who gets what materials from whom or who gets what wages from whom.

My initial answer was to suggest that he visit the floor of the Chicago Mercantile Exchange where commodities such as wheat, cotton, silver, and gold are traded. This answer understandably baffled our host, so I went on to elaborate on the fact that there was no single person—or even committee of persons—"in charge of materials distribution." There are a Department of Commerce and a

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Department of the Interior that are concerned with materials production and distribution in a wholly different way. But they do not determine who gets how much of what. They collect information, examine the situation in various industries, evaluate legislation, and so on. Legislation (for example, tax and foreign trade laws) certainly affects the course of materials prices and distribution, but no single person or political body is "in charge of materials distribution" in the sense in which there is or has been such a person or political body in China or the Soviet Union. In consequence, I was forced to answer in terms that my host found extremely difficult to comprehend. Needless to say, that is not a criticism of him. Given his background, it is almost inconceivable that he could have understood how the market can distribute a variety of materials among millions of different people for thousands of uses untouched, as an ad might say, by political hands.

The miracle of the market is precisely that out of the chaos of people screaming at one another, making arcane signals with their hands, and fighting on the floor of the Chicago Mercantile Exchange, somehow or other the corner store always seems to have enough bread, the bakery always seems to have enough flour, and the miller always seems to have enough wheat. That is the miracle of the way the market coordinates the activities of millions of people, and does so in a wholly impersonal way through prices that, if left completely free, do not involve any corruption, bribes, special influence, or need for political mechanisms.

Let me now turn more directly to the topic at hand. In some ways, referring to "the market" puts the discussion on the wrong basis. The market is not a cow to be milked; neither is it a sure-fire cure for all ills. In literal terms, the market is simply a meeting of people at a specified place and time for the purpose of making deals. Needless to say, "meeting" and "place" are often euphemisms; they do not involve physical getting together. As of the moment, there is a market in foreign exchange that encompasses the world. People get together through satellites, telephones, and other means. Moreover, the deals made in or through a market are not restricted to those involving money, purchases, or sales. Scientists who cooperate with one another in advancing their discipline, whether it be physics, chemistry, economics, or astronomy, are effectively making deals with one another. Their market is a set of interrelated journals, conferences, and so on.

The market is a mechanism that may be mobilized for any number of purposes. Depending on the way it is used, the market may contribute to social and economic development or it may inhibit such development. Using or not using the market is not the crucial distinction. Every society, whether communist, socialist, social democratic, or capitalist, uses the market. Rather, the crucial distinction is private property or no private property. Who are the participants in the market and on whose behalf are they operating? Are the participants government bureaucrats who are operating on behalf of something called the state? Or are they individuals operating directly or indirectly on their own behalf?

That is why, in an earlier paper delivered in China, I advocated the widest possible use not of the market but of "free private markets" (Friedman [1980] 1982). The words "free" and "private" are even more important than the word "market." The wider use of the market that is sweeping the world is better described as "privatization"—transferring government-owned enterprises to private hands and thereby giving greater scope to the invisible hand of which Adam Smith wrote. In 1987 alone, over $90 billion of assets and enterprises were privatized by governments around the world.

In this paper I propose to discuss some of the problems that arise when a society tries to replace a command economy with the invisible hand of the market. Those problems are not restricted to societies that have tried to use command as their basic economic mechanism, such as China and the Soviet Union. The same problems arise in Western economies, such as the United States, Great Britain, and Germany, in which command elements have become more extensive over time and in which there are attempts to reverse that process. Privatizing government-owned enterprises in the West, such as the postal service in the United States and railroads and utilities in other countries, raises problems that are identical with those that arise in replacing command and government ownership by voluntary cooperation and private ownership in China and the Soviet Union. In consequence, China can learn a great deal by studying the experience of privatization in Western countries. At the moment, the most extensive experience of that kind is doubtless in Great Britain. Much has been written about the British experience, and it provides many instructive examples about correct and incorrect ways to privatize.[1]

I shall organize my discussion under three headings: partial versus total decontrol (or deregulation or privatization); gradual versus immediate decontrol; and overcoming political obstacles or, in more technical economic terms, short-circuiting rent seeking. Although the same issues arise whatever the domain in which command is replaced by voluntary cooperation—whether economic, political, or social—I shall restrict my comments to the economic domain. A

[1]An excellent source for Britain and other countries is Hanke (1987).

concluding section discusses the general problem of the tyranny of the status quo.

## Partial versus Total Decontrol

Introducing a greater role for private market mechanisms in one sector of an economy may be partially or completely frustrated by the limited scope of the change. Consider what has been regarded as a major move toward wider use of the market, namely creation of the European common market and the attempt to achieve free trade among the common market countries. It has now been nearly 40 years since the Schuman plan for a coal and steel community was adopted, yet no observer will dispute that free trade within the common market is still an ideal rather than a reality. The latest bit of evidence is the recent agreement to *really* eliminate all barriers by 1992. Had the initial common market agreement been successful, that elimination would have been achieved many years ago. What was the problem? Why is there no real United States of Europe? In my view, the answer is that decontrol was adopted even in principle only for goods and services but not for money. The separate countries retained full authority over their national moneys. More important, they refused to adopt a system of freely floating exchange rates—that is, the free exchange of one currency for another at whatever rates of exchange were voluntarily agreed to in free private markets. The refusal to let the private market determine the rates of exchange among currencies was a fatal weakness.

I first reached that conclusion in the fall of 1950 when I spent a few months as a consultant in Paris to the then Marshall Plan agency. My assignment was to assess the likely consequences of the proposed coal and steel community. I concluded that free trade within a common market could not be achieved unless currencies as well as goods and services were freed from government control. That analysis was the basis for my article on "The Case for Flexible Exchange Rates" published in 1953. As I stated in that article (p. 157):

> A system of flexible or floating exchange rates—exchange rates freely determined in an open market primarily by private dealings and, like other market prices, varying from day to day—[is] absolutely essential for the fulfillment of our basic economic objective: the achievement and maintenance of a free and prosperous world community engaging in unrestricted multilateral trade. . . . Liberalization of trade, avoidance of allocations and other direct controls, both internal and external, harmonization of internal monetary and fiscal policies—all these problems take on a different cast and become far easier to solve in a world of flexible exchange rates and its corollary, free convertibility of currencies.

Experience during the 35 years since that article was published has, I believe, provided much additional evidence for the validity of this proposition.

Currently, China is faced with precisely the same problem. But my purpose in discussing it here is not to present again the case for a system of freely floating exchange rates but rather to give a striking illustration of how limiting decontrol or privatization to one area, while not extending it to closely related areas, can largely frustrate the basic objective.

A second example is from the United States. Although nominally private, U.S. airlines were subject to extensive government control with respect to the prices they could charge and the markets they could serve. Deregulation of the airlines in 1978 has enhanced competition, resulted in widespread and substantial reductions in prices, and increased the range of services. In consequence, there has been a major expansion in the volume of air traffic. However, while U.S. airlines were deregulated or, as I would prefer to put it, privatized, airports were not. They remain government-owned and operated.[2] Private enterprise has had no difficulty in producing all the planes the airlines find it profitable to use, and private airlines have had no difficulty in finding pilots or attendants. On the other hand, planes are often delayed because facilities or provisions for landing them at government-run airports are inadequate, at great inconvenience to passengers. Naturally, the government responds by trying to blame the private airlines: It has started requiring them to report delays in meeting their scheduled arrival times and publishing summary reports on the on-time performance of the several airlines. Repeated proposals have been made that—even if government retained the ownership and operation of the airports—rights to gates, both with respect to number of gates and to the times at which they are to be used, should be auctioned off. Unfortunately, the opposition of airlines, which have vested interests in the gates and times assigned to them by government agencies, has prevented the adoption of even such incomplete reforms. Of course, a far better solution would be to privatize the airports.

A third example is privatizing some areas of manufacturing while keeping the production or pricing of the raw materials under government control. The failure of the prices of the raw materials to conform to their market value means that private operation, however efficient privately, may be socially wasteful. Let me illustrate with an extreme

[2] In Britain, however, the British Airports Authority, which controls some airports, has been privatized.

example that I came across in India many years ago. It had to do with the manufacture of bicycles in a small community in the Punjab. The government of India controlled the production of steel and rationed the output to users, rather than auctioning off the steel produced at whatever prices the market would yield. As a result, the producers of bicycles could not get the amount of steel they were willing to buy at the officially set price of steel. However, there was a private market in finished or semifinished steel products. The bicycle manufacturers supplemented their government ration of steel by buying semifinished steel products and melting them down—hardly an efficient way to convert iron ore and coal into bicycles.

Let me cite some obvious examples for China. Introduction of a considerable element of privatization in agriculture has produced a remarkable increase in agricultural output and productivity—the most dramatic manifestation of China's success in widening the use of the private market. But it is clear that the very success has created a real problem. The overwhelming majority of the Chinese population is employed in agriculture. Even a relatively small improvement in agricultural productivity means the release from agriculture of workers who can now be more usefully employed in industry. Yet, the bulk of industry remains in the command economy; it has not been privatized, deregulated, or fully subjected to the competitive market process.

There has been a real attempt to change the way government-owned enterprises operate in China. The people in charge have been told to use market mechanisms, and an attempt has been made to provide incentives for them to do so. However, as long as industrial enterprises are government-owned, there are severe limits to the ability of politically sensitive managers (bureaucrats) to respond effectively to market pressures. The most serious limitation is on flexibility, that is, on the willingness or ability of managers in state-owned enterprises to be venturesome, to undertake risky projects that are likely to fail but have a real, if small, chance of spectacular success. Again, the problem is universal. Every study of the United States or Great Britain demonstrates that small enterprises—not the mega-corporations that are household names—are responsible for most of the new jobs. In China, the opportunity for such private enterprises is narrowly limited.

A much wider privatization of economic activity would greatly reduce the difficulty of absorbing the workers released from agriculture. That is precisely what happened in the United States and in the rest of the world during the 19th and 20th centuries. The fraction of the American population employed in agriculture in the early 19th century was over 90 percent—not far from the fraction currently employed in China—but it is now 2 or 3 percent. True, the transition in the West took much longer and proceeded at a more gradual pace than either should be or can be hoped for in China. Nonetheless, if the command sector of the economy had been as extensive in the United States then as it is now, let alone as extensive in China, the transition would never have occurred to anything like the same extent. The experience of Russia over the past 70 years is persuasive evidence. The way to expedite the transition in China is to proceed with privatization as rapidly and on as wide a scale as possible. Private enterprises would then spring up all over the place to absorb the working force.

A second example for China is similar to the problem I described for the common market: the difference between the extent of freedom in the production and distribution of goods and services and in the production and distribution of money. The substantial freeing of many prices, particularly those of agricultural and similar goods, has not been accompanied by the privatization of the banking system. As I understand it, the Chinese government indirectly determines what happens to the money supply through the credits it grants state enterprises. One result has been a rapid increase in the quantity of money and, not surprisingly, rapid upward pressure on prices, so that inflation, both open and repressed, has reared its ugly head.

It is much easier to point out the problems raised by partial use of the market than it is to draw any explicit implications for policy. It is easy to say that the best thing to do is to go all the way. However, in many really interesting and important cases, it is simply not politically feasible to do so. It would be clearly helpful in such cases to have some maxims that would suggest a way to draw the boundaries. However, it is not easy to do so in the abstract. I suspect that the only possible way to proceed is to analyze each case separately in light of the general economic principles embodied in price and monetary theory.

## Gradualism versus Shock Treatment

When should reform be gradual, and when is radical and immediate change appropriate? One alternative is illustrated by the tale of the tortoise and the hare, when the "slow but steady" tortoise reaches the finish line ahead of the much speedier but more erratic hare; The other is illustrated by the maxim, there is no sense in cutting a dog's tail off by inches. This is one of the most difficult problems encountered in widening the scope of the market. Let me illustrate with foreign trade. Suppose a country that has had high levels of tariffs decides to move to a free trade position. The case for moving gradually is clear. Capital has been invested in ways that will no longer represent an effective use of private resources under the new conditions. Much of that capital is in the form of machinery, buildings, human skills, and the like. Is it not clearly both more equitable and more efficient to reduce the tariffs gradually? That would give the owners of specialized resources the opportunity to withdraw their capital gradually and thus would reduce the costs imposed on them by the change.

The case for eliminating the tariff in one fell swoop, that is, for shock treatment, is more subtle, yet at the level of economic efficiency, compelling. Insofar as it is economically efficient to use the specialized resources in the absence of a tariff, they will be used. If any return over marginal cost can be obtained by continuing to use the specialized human and other resources, it is better to get that return than to get nothing. The burden would be imposed on the owners of the specialized resources immediately, but technical disinvestment would proceed only as rapidly as the specialized labor and other resources could be employed more productively elsewhere. On the other hand, gradual reduction in the tariff makes it privately profitable to continue using the specialized resources at a higher level than is socially efficient, thereby imposing unnecessary costs on the community.

The possibly valid arguments for gradualism are not technical and economic but equitable and political, and neither of these is clear-cut. The individuals who invested in the protected industries did so with the full knowledge that the authorities that imposed the tariffs could eliminate them. The existence of such a possibility kept down the amount of capital invested in the industry and permitted the owners of such capital to earn a higher return than otherwise. Why is it now equitable for consumers to bear part of the owners' costs of adjustment? Politically, gradualism encourages the protected industries to spend resources to reverse the decision.

The analysis is complicated even further by considering the activities that will tend to expand under the new circumstances, that is, the industries that will replace the former so-called protected industries. Here, too, issues about efficiency, equity, and politics require attention.

Ending an ongoing inflation raises similar problems. Eliminating inflation in one fell swoop, if not anticipated long in advance, may cause widespread capital losses. Long-term contracts entered into with one expectation about the likely rate of inflation may now suddenly be rendered inappropriate. The case on equity grounds for a gradual transition is far stronger for moderate degrees of inflation than for tariffs. The effects of both the prior inflation and its unanticipated ending are more pervasive and affect more people who have not only been harmed rather than benefited by the prior inflation but would be harmed again by its abrupt end. Reducing inflation gradually eases the transition and reduces the cost of achieving noninflationary growth.

However, much depends on the height of the inflation. If inflation is extremely high—at annual rates in triple digits—the situation is very different. Almost all participants in the market will have adjusted their arrangements so that any longstanding commitments are fully indexed. Abrupt disinflation will impose few costs because financial and other institutions have been adapted to radical changes in the rate of inflation. Indeed, such adaptations represent a major cost of high and erratic inflation. Gradual elimination is sometimes not even feasible because there is not time enough—the dog will be dead before its extra long tail can be cut off by inches.

Direct controls over prices—whether general or specific, for example, on rents or exchange rates—are almost always best ended at once. Margaret Thatcher properly ended exchange rate controls in Britain overnight and completely. Gradual adjustment only prolongs the harm done by controls and provides unjustified benefits to "insiders." The shortages and queues and other distortions produced by trying to hold prices below their market level would continue though they might get shorter, and additional problems arise because gradualism encourages speculation about reversal and encourages opponents to seek reversal. A similar proposition holds for attempts to keep prices above market levels—as is so amply demonstrated by the agricultural policies of the United States, Japan, and the common market.

## Overcoming Political Obstacles

This subject has already inevitably intruded into the preceding section. The general issue here is how to overcome political obstacles to widening the market. The danger is not alone that these obstacles will frustrate the attempt to free the market but equally that overcoming political obstacles will destroy the advantages of freeing the market. The challenge is to find ways to overcome obstacles that do not have those effects. The experience of the West with privatization is particularly helpful in this connection. Perhaps the most extensive body of experience and the experience that has been most widely analyzed is the British experience with privatization, and I strongly recommend to our Chinese friends seeking to widen the market that they examine the evidence of privatization in Britain.

A simple case from the United States that illustrates the problem is privatizing the post office. The U.S. Postal Service has a monopoly in first-class mail because of the private express statutes, which make it a crime for individuals to offer common-carrier first-class service. Various attempts to do so have only succeeded in prosecution, which has ended the attempts. Privatization has been creeping in at the margin, first in the form of alternate parcel service. The United Parcel Service, a strictly private enterprise, and other parcel delivery companies have taken over the bulk of the Postal Service's prior business. In addition, private messenger services have developed, of which the best known is Federal Express, which has been so successful that numerous competitors have emerged. Developments that technological advances would have encouraged no matter how postal service was organized have doubtless been speeded up. Examples are electronic mail via computers and telephones, and facsimile service, again over telephones. These examples illustrate the ingenuity of private markets in exploiting the opportunities offered by the inefficiency of government enterprises.

Repeated attempts have been made to seek the repeal of the private express statutes so that private individuals and enterprises could compete with the U.S. Postal Service. However, such attempts always bring violent protests from the postal employee unions, from the executives of the Postal Service, and from rural communities that feel they would be deprived of postal service. On the other hand, few people have a strong and concentrated interest leading them to favor repealing the private express statutes. Entrepreneurs who might in fact enter the business if it were open to private entry do not know in advance that they would do so. Hundreds of thousands of people who would doubtless obtain employment in a privately developed postal system do not have the slightest idea that they would do so.

I recall a personal experience. I urged a congressman who believed as strongly as I did that it would be desirable to repeal the private express statutes to introduce a bill to that effect. He said, "You and I know the powerful groups who will testify and lobby against such a bill. Can you give me a list of people who will be equally willing to testify and work in favor of such a bill? People who will have some influence on Congress? People with a strong personal interest other than academic economists?" I admitted that I could not do so and he never introduced the bill. Vested interests have been built up in the postal monopoly. Few vested interests have been built up in opposing the postal monopoly, though there are some. That situation may be changing as corporations such as Federal Express and United Parcel Service begin to see the possibilities open to them.

One way to overcome the opposition to privatization, widely used in Britain, is, as described by Robert Poole (1988, p. 25),

> to identify potential opponents and cut them in on the deal, generally by means of stock ownership. Two specific applications of the principle are employee stock ownership and popular capitalism. . . .
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> The opportunity to become shareholders can dramatically change the incentives of unionized civil servants, as illustrated in the case of British Telecom. Union officials denounced the planned privatization of Telecom, telling their members not to purchase the shares which were being offered to them at a discount. Yet in the end, sensing the chance to make money, some 96 percent of the workforce bought shares.

Poole also uses British Telecom to illustrate the second technique, popular capitalism: "To encourage telephone customers to buy shares, they were offered vouchers granting them a discount on their phone bills if they held their shares for at least six months. And to prevent institutions and large firms from buying up the lion's share, initial purchases were limited to 800 shares per buyer."

A pitfall to be avoided in adopting such expedients is to sweeten the deal by converting a government monopoly into a private monopoly—which may be an improvement but falls far short of the desirable outcome. The U.S. Postal Service illustrates that pitfall as well as the fallacy that mimicking the form of private enterprise can achieve the substance. It was established as a supposedly independent government corporation that would not be subject to direct political influence and that would operate on market principles. That has hardly been the outcome, and understandably so. It remained a monopoly and never developed a strong private interest in efficiency.

My own favorite form of privatization is not to sell shares of stock at all but to give government-owned enterprises to the citizens. Who, I ask opponents, owns the government enterprises? The answer invariably is, "The public." Well, then, why not make that into a reality rather than a rhetorical flourish? Set up a private corporation and give each citizen one or one hundred shares in it. Let them be free to buy or sell the shares. The shares would soon come into the hands of entrepreneurs who would either maintain the enterprise, for example, the postal system, as a single entity if it was most profitable to do so or break it up into a number of entities if that seemed most profitable. I know only one major case in which this procedure was followed, namely in British Columbia (see Ohashi and Roth 1980, part 1). Unfortunately, the collapse of energy prices made this venture less than an outstanding success. Nonetheless, it is well worth studying.

A final example illustrates the point in another way. The Russians have permitted small private plots in agriculture. Those private plots are estimated to occupy about 3 percent of the arable land in the Soviet Union, and roughly one-third of all domestic food products in the Soviet Union are sold as coming from those private plots. I have chosen my words carefully. I did not say that one-third were "produced on those private plots," because in my opinion that would not be correct. Much of the food sold as coming from the private plots has indeed been produced on them, but I strongly suspect that much has also been diverted from collective farms.

For decades, it has been clear to the rulers of the Soviet Union that they could increase the domestic output of agriculture substantially by increasing the size and role of the private plots. Why have they not done so? Surely not because of ignorance. The answer clearly is that privatization would tend to establish independent centers of power that would reduce the political power of the bureaucracy. The rulers regarded the political price they would have to pay as higher than the economic reward. As of the moment, largely I suspect under the influence of the extraordinary success of such a policy in China, President Gorbachev is talking about a considerable expansion in private plots. It is by no means clear whether he will succeed.

## Tyranny of the Status Quo

The problems of overcoming vested interests, of frustrating rent seeking, apply to almost every attempt to change government policy, whether the change involves privatization, or eliminating military bases, or reducing subsidies, or anything else. The resulting "Tyranny of the Status Quo," as my wife and I entitled a recent book (Friedman and Friedman 1984) discussing a range of such cases in the United States, is the major reason that political mechanisms are so much less effective than free-market mechanisms in encouraging dynamic change, and in producing growth and economic prosperity.

Few simple maxims exist for overcoming the tyranny of the status quo. But there is one that ties in closely with the earlier discussion of gradual versus abrupt change. If a government activity is to be privatized or eliminated, by all means do so completely. Do not compromise by partial privatization or partial reduction. That simply leaves a core of determined opponents who will work diligently and often successfully to reverse the change. The Reagan administration repeatedly attempted, for example, to privatize Amtrak (the railroad passenger service) and to eliminate the Legal Services Corporation. In each case, it settled for a reduction in budget, achieving a fairly transitory victory. On the other hand, the complete abolition of the Civil Aeronautics Board gives far greater hope that airline deregulation is here to stay.

In conclusion, there are better and worse ways to privatize a command economy, but there is no magic formula for shifting painlessly from a command to a voluntary exchange economy. Nonetheless, the potential rewards are so great that, if the shift can be achieved, transitional costs will pale into insignificance. It is a tribute to the current leaders of China that they recognize that the potential gains dwarf the transitional costs and that they are engaged in a serious effort to make the transition. The Chinese people would be the main but by no means the only beneficiaries of the success of this effort. All the peoples of the world would benefit. Peace and widely shared prosperity are the ultimate prizes of the worldwide use of voluntary cooperation as the major means of organizing economic activity.

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# Planning and the Market

*Pu Shan*

## Socialism in Theory and Practice

In economic literature, the question has long been raised whether the socialist system based on public ownership of the means of production could effectively organize economic activities. One point of view is that the socialist system is incompatible with the market mechanism and therefore cannot rationally allocate resources and organize economic activities. As early as the 1920s, Ludwig von Mises had argued strongly for this viewpoint. Oscar Lange, Abba Lerner, and others, however, offered the counterargument and demonstrated that in theory the socialist system could also make use of the market principle. Although their argument has sometimes been labeled "playing the game of competition" or "playing at capitalism," the theoretical question is basically resolved.

Another point of view is that although the socialist system could in theory make use of the market mechanism, public enterprises lack the incentive to observe the market principle and therefore cannot respond effectively to market pressures. Friedrick Hayek has long been of that opinion. Professor Friedman's argument seems to belong to the same category. The practical problem does exist. Since no socialist country has yet had a completely successful experience in making use of the market, it should be recognized that this practical problem remains unresolved.

## The Direction of China's Economic Reform

The direction of China's economic reform is toward the development of a planned commodity economy based on socialist public ownership and not toward what Friedman calls "free private mar-

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kets." After the founding of the People's Republic in 1949, a vast amount of manpower, materiel, and financial resources were mobilized for large-scale economic development. Under a planned economy, with a relatively comprehensive industrial structure, China met the basic needs of the masses and achieved remarkable success. Nevertheless, the neglect of the role of the market mechanism, the overcentralization of the planning system, and the lack of production units with autonomous decisionmaking power affected more and more seriously the vitality of the economy. One of the important tasks of the current economic reform is to allow full play to the positive role of the market mechanism. Mandatory planning, therefore, is to be replaced by "guidance planning," the scope of prices set by the state is to be reduced, and the scope of prices determined by the market expanded. Moreover, even mandatory planning and state-set prices should take full account of market responses and the role of the law of value. The overall direction is "the state regulates the market and the market guides the enterprises."

Economic reform also bears on the question of ownership. The socialist economic system is based on public ownership of the means of production, including state ownership (mainly in the form of state enterprises) and collective ownership. In the past, however, there was an overemphasis on state ownership and a neglect of collective ownership, especially the necessary supplementary role of individual private ownership. A major component of the reform is to develop actively collective and individual economies while maintaining the basis of public ownership, and to develop extensively various forms of contractual management and cooperative management among the state, collective, and individual economies on a voluntary and mutually beneficial basis. China does not intend to privatize extensively its state enterprises. But in these enterprises, there will also be a separation of ownership and management, and through such measures as the management contract system the interests of the managers will be directly related to the economic efficiency and the profits and losses of the enterprises. Under these provisos, China is experimenting with stock ownership. The purpose is to render the state enterprises more responsive to market adjustments.

In this connection, Professor Friedman mentioned the very important problem in China of transferring agricultural workers to industry. The actual situation is that during the process of economic reform in China, the rapid development of rural village and township enterprises has played a remarkable role in absorbing surplus agricultural workers. In recent years, the number of workers absorbed in village and township enterprises has been increasing by close to 10 million annually. These enterprises are mainly collective enterprises established by towns and villages.[1] In 1987, the number of workers in village and township enterprises amounted to 88 million, and their output value accounted for one-fourth of the total value of industrial output of the whole country. It is noteworthy that the large-scale transfer of agricultural labor to industry has been accomplished amid unprecedented prosperity in the rural economy, unlike many other countries that went through the painful process of widespread bankruptcy of farmers during the 19th and 20th centuries.

The economic efficiency of China's state enterprises is still far from being satisfactory. China's economic reform is also faced with many difficulties. There is still no sufficient factual evidence, therefore, to prove that the planned commodity economy based on Chinese-style public ownership will necessarily be superior to an economic system based mainly on "free private markets." On the other hand, judging from the actual evidence, any opposite conclusion seems also unwarranted.

## The Extent and Rapidity of Reform

Professor Friedman also raised the problems of "partial versus total decontrol" and "gradual versus immediate decontrol" in economic reform. These are very pertinent issues in the economic reform in China. "Partial versus total" and "gradual versus immediate" are of course relative concepts and closely related concepts. Relative to complete "free private markets," a planned commodity economy based on public ownership might be considered as a kind of partial reform. But no significant reform can be accomplished overnight, and any gradual reform inevitably creates continuous situations of partial reform.

China's economic reform has adopted the approach of gradual implementation. Judging from the actual situation in China, this approach has avoided irretrievable mistakes in the reform and serious volatility in economic activities. Moreover, through continuous demonstration of the practical benefits of economic reform, the gradualist approach has reduced resistance to reform. But this approach also has created the coexistence of the old and the new system and has created many new difficulties. For instance, at the present time, there are different prices for many of the same products, which has led to serious malpractices. As such, price reform is increasingly becoming

[1]According to 1985 statistics, collective enterprises accounted for about 60 percent of the workers in village and township enterprises, whereas other cooperative enterprises accounted for 13 percent and individual or private enterprises for 27 percent.

the key to the whole economic reform. Yet price reform is seriously hampered by such constraints as inflationary pressures.

Price reform concerns the whole economic structure and there is no simple choice among "partial or total" and "gradual or immediate" approaches. What is important is to have a comprehensive and coordinated program, and the steps and speed of the implementation of this program should take into consideration the actual situation in various fields as well as their interrelationship. The State Council has already put forward a preliminary program of price and wage reform, and the program is under extensive discussion and examination.

## The Question of Political Reform

The deeping of reform will inevitably involve adjustments of economic rights and benefits, and will therefore inevitably meet with political resistances and obstacles. This is why it is necessary to carry out political reform alongside economic reform. At the present time, the foremost task of political reform is to ensure the correct and successful implementation of the economic reform. But this task can rely only on the evolution and development of socialist democracy, rather than on such devices as "to identify the potential opponents and cut them in on the deal." From a long-run point of view, it is of vital importance that at the same time as material production is developed, the ideological and moral standards of members of society be raised—so as to establish gradually a new type of social relation among humankind. This is indeed the essence of socialism.