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**Models of Labour Market Reform:  
Poland, Sweden and the Case of China**

Yong Jie Qu

A Thesis

In

The Department

Of

Sociology and Anthropology

Presented in Partial Fulfilment of the Requirements  
For the Degree of Master of Arts at  
Concordia University  
Montreal, Quebec, Canada

November 1998

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**ii**

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# **ABSTRACT**

## **Models of Labour Market Reform: Poland, Sweden and the Case of China**

Yong Jie Qu

There has been a general consensus that unemployment is a result of an economy that fails to generate substantial growth. Economic growth itself is based on efficient production, international competitiveness and an efficient labour market system. It is also generally agreed among economists that governments share responsibilities in terms of promoting growth and stabilising the economy. However, there are significant differences in the roles played by governments, and the degree to which they are active participants in market for labour. This thesis considers Poland's approach to a market economy as a case representing a "passive" model. Sweden, on the other hand, represents an "active" model. Through a cost-benefit analysis, this thesis finds that both Polish and Swedish models provide valuable lessons for China's ongoing labour market reform. However, it is inconclusive to claim which model is superior to the other. Instead, the thesis argues that the effectiveness of labour market policies depends on unique factors in each country. In China these factors include the size of the labour force, the presence of a stagnant state-controlled industrial sector, and a past history of treating employment as both an economic and welfare issue.

## **Table of Contents:**

<b>List of Tables:</b> .....	VI
<b>List of Figures:</b> .....	VIII
<b>Chapter 1: The Introduction</b> .....	1
<b>Chapter 2: The Theory Review</b> .....	16
I. The Working of a Simple Competitive Labour Market .....	18
II. Theories of Unemployment .....	23
1. The Classical and Neoclassical Explanation .....	23
2. Keynesianism Versus Monetarism .....	26
3. The Rational Expectation Explanation (The New Classical) .....	32
4. Social Corporatism .....	33
<b>Chapter 3: Labour Market Reform: 1978 -1994</b> .....	37
I. Major Thrusts of Reform .....	40
1. Rural De-collectivisation .....	40
2. The Emergence of Rural Industry .....	42
3. Urban Labour Market Reforms .....	46
II. The Debate on Labour Market Reform .....	47
III. The Labour Market Reform Measures .....	52
IV. Enterprises Reform & Bankruptcy Law .....	56
<b>Chapter 4: The Consequences of Government Labour Market Reform:Unemployment Versus Underemployment</b> .....	60
I. Population, Labour Force and Participation Rate .....	61
II. The Labour Market .....	63

III. Open Unemployment .....	65
IV. The Un-registered Unemployment and Underemployment .....	70
V. The Nature and Causes of Unemployment .....	72
<b>Chapter 5: The Role of State and the Problem of Unemployment ...</b>	<b>77</b>
I. The Search of Market: The Polish Model .....	80
1. The Balcerowicz Plan .....	83
2. Economic Liberalisation and Macroeconomic Stabilisation .....	83
3. Privatisation and the Reform of SOEs .....	85
II. The Corporatist Swedish Model .....	87
<b>Chapter 6: The Polish and Swedish Models Compared .....</b>	<b>92</b>
I. The Consequences of Poland's Economic Transition .....	92
II. The Consequences of the Swedish Active Labour Market Policy .....	97
<b>Chapter 7: Which Model for China? .....</b>	<b>108</b>
<b>Chapter 8: The Conclusion .....</b>	<b>120</b>
<b>Notes .....</b>	<b>128</b>
<b>Bibliography .....</b>	<b>136</b>



## List of Tables:

Table 3-1:	The Growth of Gross Output Value of Agriculture, 1978-92 (in percent) .....	42
Table 3-2:	Source of Employment Growth by Type of Enterprise and by Sector, 1985 - 1991 .....	45
Table 3-3:	Exports of Non-state Owned Rural Enterprises, 1985 - 1992 .....	45
Table 3-4:	Share of Industrial Output by Type of Enterprises, 1980 - 1991 .....	46
Table 3-5:	Performance of Industrial SOEs in Central Budget .....	57
Table 4-1:	China's Population and Population Density in Comparison .....	61
Table 4-2:	China's Labour Force Participation Rate in Comparison ..	62
Table 4-3:	SOEs' Operating Losses and the State Subsidies .....	65
Table 4-4:	Urban Unemployed and the Rate of Unemployment (millions) .....	66
Table 4-5:	Labour and Employment Under Eighth Five-year Plan (millions) .....	71
Table 5-1:	Estimates of the Rate of Unemployment and the Rate of Inflation in Post-communist Poland .....	84
Table 6-1:	Poland's Main Economic Indicators 1988 - 1991 (annual rates in percent) .....	93
Table 6-2:	Unemployment Indicators .....	94
Table 6-3:	Expenditure on Labour Market Programs (LMPs) per Unemployed Person (in US) .....	99

Table 6-4:	Expenditure on labour Market Policy As Percentage of GNP, Share of Active and Passive LMP Measures in the OECD Countries 1985 - 1991 .....	100
Table 6-5:	Internal Migration in Comparison, 1970 - 1987 (%) .....	101
Table 6-6:	Unemployment Rates in OECD Countries, 1960 - 1991 (period average as percent) .....	102
Table 6-7:	Economic and Industrial Development in Comparison, 1870 - 1976 .....	103
Table 7-1:	Number of State Firms Between 1990 and June 1994 (Poland) .....	111

**List of Figures:**

Figure 2-1 Illustration of the Working of Supply & Demand in Labour Market ..... 20

Figure 2-2 Equilibrium in a Competitive Labour Market ..... 21

Figure 2-3 Demand Shifts, Wages and Employment ..... 22

# Chapter 1: Introduction

At the end of the 70's, China embarked on the road to economic reform. The first step of the reform program was undertaken in the agricultural sector when the People's Commune system was abolished and farmers became responsible for their own profits and losses. Although the land now legally belongs to the state, farmers can lease it for fixed periods and there is a tacit agreement that leases will be renewed by the state should farmers so desire. Thus, the land has in fact become private (Minami, 1994:77-9). Furthermore, part-time work in areas other than agrarian production has been totally deregulated. Many resourceful farmers left agriculture and became either collective or individual entrepreneurs, who now employ a significant portion of rural labour. These privately owned businesses are indeed very similar to the private industries in capitalist countries. In addition, agrarian products that were once controlled by the state, are now allowed for free trade (Watson, 1984; see Chapter 3).

Urban reform began in 1984 and the aim was to stimulate the economy by decentralising state control and increasing individuals' incentive to work. Numerous reforms have been enacted: state-owned enterprises (SOEs) are now free to sell their surpluses and to use their after-tax profits without any state interference; more and more commodities are being priced

in accordance with market demand; private businesses which were banned during the period of Cultural Revolution have developed rapidly; the issuing and purchasing of stocks are permitted, and it is possible for people to own houses and flats throughout China.

As a result of the reforms, the Chinese economy grew at an average rate of 10 percent in the 1980's. This growth rate is impressive even after population growth is taken into account. Per capita income grew 9 percent per year in the 1980's (Statistical Yearbook of China 1994, P. 51-2). This strong growth continued in the first half of the 90s. The major contribution to this unprecedented growth was the spectacular development of the non-state sector, especially the rural industries known as the Township & Village Enterprises or TVEs, private industries, and jointventures with foreign investors.

On the other hand, the state sector has suffered stagnation (World Economic Survey 1993, P. 185-225). Despite the many attempted reform measures, many phenomena that have been long associated with the command system remain unchanged (see Chapter 3). Consequently, the state sector's share of production has shrunk significantly. The non-state sector was initially small, with a share of only 19.3 percent of the total industrial output in 1978, versus the state sector's 80.7 percent. However, by 1994 the

non-state sector's share had jumped to 57 percent, while the state sector had shrunk to only 43 percent (Morton, 1995; Statistical Yearbook of China, 1995:135, also see Table 3-4).

The main problem facing the state sector is that the objectives of SOEs (state owned enterprises) are not limited to maximising profits, they are also required to fulfil other social obligations. SOEs are the major source of employment and must contribute to social welfare. They are forced to employ more workers than their production requires (Minami, 1994, p. 208-210). Overstaffing is common in most SOEs. According to Kornai (1982), these under-utilised workers are indeed 'unemployment on-the-job'. Under this labour system, wages paid for 'employment' were in fact similar to unemployment compensation (Kornai, 1982; 1986; Prybyla, 1989:1-18). In addition, the large SOEs have to provide housing, medical insurance and education for their employees. These factors make SOEs overstaffed and inefficient.

It was widely believed that a market labour allocation system would make SOEs more efficient. Starting from the early 1980's, the Chinese leadership sought to introduce measures to set up a viable labour market system (see chapter 3). These reform measures included: shedding overstaffed employees, minimising SOEs' social obligations and

strengthening management power. For those remaining uncompetitive SOEs, the first bankruptcy law was put into effect in early 1987, and was intended to push the uncompetitive SOEs out of business, consequently re-directing the resources to those economically sensitive sectors.

However, the question is what negative consequences might incur as a result of the labour market reform? These might include labour dislocation, unemployment and the potential threat to socio-political stability. The initial practice of labour market reform in China has already created a considerable army of unemployed. The experiences of other transitional economies also proved that unemployment is a major problem that is often inevitable.

In the case of China, SOEs continue to employ 70 percent of total industrial workers, with almost 70 percent of SOEs in the red, and 41 percent suffering deficits in 1995. Under a market system, these SOEs would possibly not survive. The job losses would be substantial if a strict market labour allocation system were applied. Fearing massive unemployment and consequential socio-political instability, the Chinese government is cautious about labour market reform in the state sector. In the past years, only a small fraction of SOEs were allowed to go bankrupt, and they were usually small- or medium-size SOEs. Li Peng, the Chinese Premier, insists on a 'go-slow' approach to the labour market reform (Ecker, 1996).

Meanwhile, the losses associated with SOEs are continuing to grow. In the first nine months of 1995, SOEs' total losses estimated at about ¥5 billion RMB (\$588 million US dollars), which corresponded to an approximately 19 percent jump over the same period in 1994 (Kapp, 1996). The money-hungry SOEs are causing reform 'bottle-necks', and the state banks are the major victims. According to Cai Lulun, governor of the People's Bank of China Hunan Branch, "bank loans account for over 80 percent of the total working capital of SOEs ... most of the time." He also believes that SOEs' losses are one of the major factors contributing to inflation (Macartney, 1996). The World Bank advances the same argument. It estimates that SOEs accounted for 70 percent of industrial investment in 1993, up from 61 percent four years earlier. While state firms gobble up money, private companies groan about a credit crunch. Subsidies to the SOEs are another main force driving up inflation, which hit 27 percent in 1994 (Monton, 1995).

The Chinese leadership also recognises that the problems of inflation and unemployment are the top priorities for China's ongoing market-drive reforms (Economist, 1995). In the past reform era, the inflation rate increased to 18.5 percent and 27 percent in 1988 and 1994 respectively. This forced the government to exert monetary policies, such as higher interest



rates, which exacerbated the credit crunch and plunged debt-burdened SOEs deeper into debt. The banking reforms in 1995, aimed at transferring state banks into commercial banks, also meant less funding for money-hungry SOEs. These measures brought inflation under control, but on the other hand caused a further burst of SOE losses, and an increase in unemployment as many SOEs were forced to stop or partially stop their production for lack of working capital.

Problems like these have convinced many people that SOE reform in China is getting more, not less, urgent. Yet, the key question is how should SOEs be reformed? Should the state allow loss-making SOEs to go bankrupt or be privatised, transferring the currently underemployed workers to open unemployment? Should the state be responsible for finding new jobs for the unemployed, or be obliged to ensure full employment? Or should the state be responsible only for providing temporary relief, such as basic welfare protection for those unemployed?

These are questions which have been discussed by economists throughout the history of economics. There has been consensus that the state has some role to play in the economic arena; however, there is little agreement as to the degree of state involvement in economic activity, and measures other than traditional macroeconomic policies (e.g. fiscal and

monetary policies) are especially problematic, especially are those which include the government's role in job creation, labour protection, welfare and full employment.

With regard to these questions, this thesis identifies two distinctly different economic models. On the one hand, based on the classical economic theory, it is believed that long-term unemployment often is incurred as a result of market rigidity, and that market rigidity is often the result of state intervention. Under a competitive market system, unemployment can only be temporary. This is because the market always has the tendency to reach full employment of all resources, including labour (see chapter 2). Therefore, based on this economic theory, state intervention is not recommended. Consequently, the state has little responsibility in job creation, welfare and full employment. The unemployment resulting from economic transition will only be short term, and it is the price to pay during the transition from a command to market economy. Once the capitalistic 'Law of Economics' is restored, it will guide the most needed restructuring. The incentive created under the market system will drive the economy to full employment of all available resources, including labour (Sachs, 1994:39).

On the other hand, some would question the ability of the market to achieve full employment without external forces (e.g state intervention).

They believe that the state has a significant role and should be responsible for assisting the market to restore equilibrium once off track. Inspired by this economic theory, Nordic corporatist economists pushed their stance to the far 'left' limit of capitalist economics. The state was assigned a major role in employing active measures to ensure full employment and forge rapid economic growth.

In this thesis, the recent transition experience of Poland was taken as the model to represent the classical and the neoclassical economic theory, and the Swedish model was taken to represent the corporatist model. During the transition from command to market economy, Poland applied a so called 'shock therapy' approach. It faithfully followed the classical economic theory, with limited state involvement. The state employed only macroeconomic tools, for example fiscal and monetary policies, to ensure stability during the massive economic transition. On the other hand, the Swedish government was assigned a major role in ensuring smooth restructuring in the continual changes in the country's economy. Apart from the traditional fiscal and monetary policies, the Swedish government creatively introduced Active Labour Market Policies (ALMPs) to accelerate structural economic transformation on the one hand, and ensure full employment on the other.

The two different approaches had rather significantly different results. In the case of Poland, in the immediate aftermath of the shock treatment there were significant increases in unemployment and inflation. These were also accompanied by a rapid decline of industrial production. In addition, social and political instability also posed a major threat to the reform. These results seemed to discredit the 'shock treatment' approach. However, a few years after the initial shock, the Polish economy is currently enjoying rapid growth, at levels (7.6 percent in the first quarter of 1997) that are among the best in the world (McKinsey, 1997).

The Swedes, on the other hand, employed not only traditional monetary and fiscal policies, but also measures known as 'Active Labour Market Policies' (ALMPs). Under the Swedish system, a unique wage policy aimed at narrowing wage differentials was implemented. The purpose was to push the inefficient industries or firms out of business. Meanwhile, instead of passively putting the unemployed on unemployment insurance schemes, the ALMPs included measures of employment services, training and subsidies to assist the structural/frictional unemployed in finding a job in the relatively strong economic sectors. As a result, the Swedish model increased its international competitiveness and ensured growth through a scheme of continual restructuring and adjustments.

Yet, in recent years, with the reoccurring of unemployment and declined production, the once glorious Swedish Model is under serious attack for its inability to operate under economic downturn (post-1989). High levels of unemployment and inflation are the cause of major controversies regarding the Swedish Model. Some believe that the model itself is fundamentally wrong, and that although it may have its merit in relatively good economic times, it is simply too expansive to maintain under economic downturns. Still others believe that no government bureaucrat is able to manage the national economy better than the market itself. Others would argue that the fall of the Swedish model is not the fault of the model itself, but of the government who failed to understand it and who finally betrayed the fundamentals of the model (Milner, 1989).

The causes of the decline of the Swedish model is beyond the purpose of this thesis. Instead, the thesis determines which model better fits China's unique situation, and what China can learn from the above mentioned two models.

In chapter 1, the thesis first illustrates the research problem with a broad brush. This is followed in chapter 2 by a theoretical review of the various economic theories, their views on the relation between market and state, and their recommendations on economic policies, especially policies

related to labour markets. The theory review includes the Classical, Neoclassical and Keynesian economic theories. The Corporatist economic theory was included for the purpose of the current thesis.

Chapter 3 returns to the Chinese context, and provides the reader with some background knowledge of China's latest market-driven economic reforms, with special focus on China's attempted labour market reforms.

Chapter 4 argues that a dual system of both market and command systems were created as the consequence of China's labour market reforms. On the one hand, past reforms created a significant non-state sector, composed of privately and collectively owned enterprises as well as joint ventures of the Chinese and foreign firms. This non-state sector is now the most dynamic sector of the Chinese economy. The market force is the major co-ordinating force, with little state interference. There are no unions, with an almost free flow of labour, and flexible wage. It comes close to a pure competitive labour market.

On the other hand, however, despite many attempted labour market reforms, the state owned economic sector remains uncompetitive. Close to 70 percent of SOEs are in the red, and as many as 40 percent of SOEs are currently operating on state subsidies, and would otherwise face bankruptcy. These possible bankruptcies will create significant increases in open

unemployment and the potential threat of social, political instability.

As the alternative approaches to China's reform, chapter 5 examines two political economic models. First, the 'shock therapist' model, developed on the basis of the market theory, proscribes abrupt, massive programs aimed at establishing major market institutions in a matter of two to three years. It is expected that there could be an inevitable and painful period of time, which Sachs' termed a "valley of tears," (Sachs, 1993:210). However, it is believed that unless the society intends to maintain a variant of the command system, both the government and its people have no choice but to accept the cost and absorb the impact. The model is constructed with a deep trust of market forces; it is believed that once the market incentive is in place, the fruits of transition will be possible. The costs in terms of production decline and unemployment increases are considered to be temporary. Ultimately, the market incentive will drive the production level up to its maximum potential, and this will in turn generate the necessary demand to absorb the unemployed back into the workforce.

The second model is the Swedish corporatist model. It emphasises the government role in the process of economic restructuring. The model is referred to as the corporatist model because it was developed on the basis of social consensus among the major interest groups. The social democratic

government of Sweden was deeply involved in the process and actively exerted measures to ensure growth and full employment. The results were inspiring. The Swedish workers appeared to be more movable, and low unemployment was maintained throughout the transition period. As a result, the Swedish model became the most unusual political economic model in the capitalist world. With the fall of the command economic system, the Swedish model has come to represent the outer *left* limit of a capitalist government.

In summary, influential economists in both Poland and Sweden saw efficiency as the engine of development, and believed that their economies needed to be restructured in order to achieve greater efficiency. However, the measures taken to achieve such a purpose differed significantly. For the shock therapist, an unfettered market system is only the means to an end. They are distrustful of government initiatives and ability to undertake the necessary enterprise restructuring, as opposed to private agents (Cook and Nixon, 1995:17; Cook and Kirkpatrick, 1994; Shirley and Nellis, 1991). As a result, privatisation before restructuring is recommended. The Swedish, on the other hand, gave the government significant power to remedy what they thought were the market deficiencies. Based on general public consensus, the Swedish model served not only the interests of efficiency but also those



of equity; it insisted on full employment, and to some extent, egalitarian distribution.

Chapter 6 assesses the consequences of the Polish and Swedish approaches from three main aspects: unemployment, industrial production and public policy reactions. On the one hand, Poland's period of *pain* (economic slow down, unemployment, declining of production, inflation and socio-political unease) was a bit longer than expected. Yet, the recent developments are rather inspiring, and Poland now is the fastest growing economy among Eastern European countries. Many economists predict no slow down for the Polish economy in any foreseeable period. On the other hand, the Swedish economy enjoyed rather smooth structural change, with, in fact, fabulous growth in the initial period of time. However, this model has been experiencing some difficulties in recent years.

In chapter 7, the thesis raises the question: should China learn from the Polish or Swedish Model? It is clear that, first, China, Poland and Sweden share little commonality in terms of their economic system, political arrangement and culture. Second, the project of economic transition in Poland is far from complete and further development of the Polish model had had varying results. Third, the recent crisis of the Swedish model shows it to have disadvantages.

Given China's uniqueness, it is questionable whether China would be able to absorb the initial impact that the shock treatment is likely to bring about. However, this thesis sees some merit in the Swedish Model, at least for the short term. This thesis argues that it makes more economic sense for China to spend its limited resources on active measures rather than on subsidising operations losses made by the SOEs. This is especially true when we see that China is currently spending a similar percentage of GDP on subsidising losses as the Swedish were spending on active employment measures. Furthermore, the thesis agrees that, given the enormous size of the Chinese economy, and the failure of the former central planning system, the state shows no ability to manage the national economy as efficiently as the market force. Therefore, upon the completion of the transition, the role of the government should be directed toward ensuring that the market operates in an efficient and equitable manner.

## Chapter 2: The Theory Review

Under pure command socialism, the supply of and demand for labour tends to be balanced through the ‘planning’ mechanism. In contrast to pure market capitalism, though, this is achieved not by means of fluctuations in real-wage rates, but by means of command. The communist government grants the ‘right to work’ by administrative assignment of jobs at predetermined rates of reward (Prybyla, 1969:16). Furthermore, employed persons are not allowed to change jobs of their own accord, and only transfers arranged or approved by the government are possible. Consequently, labour is not free, a labour market does not exist, and open unemployment is absent (Prybla, 1969; Minami, 1994; Kornai, 1982, 1986).

Command socialism is able to either eliminate open unemployment (if it is pure command socialism) or to keep it down (where it is not pure). On the other hand, because the command system lacks the competitive influence of a free market, it isn’t able to ensure that employed persons are efficiently utilised on the job (Kornai, 1982, 1986), or that wages relate to performance (Kornai, 1986; Minami, 1994; Porket, 1995:8).

The transition from a command to a market economy, according to the assumption of neoclassical theorists, means more incentives for efficient production through wage differentials set according to skill and work performance. It is for this reason that the market is a better system to ensure production efficiency. However, the same transition would force firms to drop the underemployed workers in order to achieve greater efficiency. In addition, firms failing to adjust accordingly could face bankruptcies. All these factors mean that unemployment will be likely to increase as a result of the transition from a command to a market economy. However, the level of unemployment is very much dependent on the speed and scale of transition, and also on the level of underemployment within firms and the firm's ability to adjust themselves to the new market environment.

Before continuing the exploration of a transitional economy, I shall look at the nature and causes of unemployment under the market economy. However, this is the very point on which economists cannot agree. The debate on the causes of unemployment has never stopped since the Great Depression of the 1930's. Consequently, no consensus has yet been reached on the measures required to reduce unemployment (Sharp, Voyer and Cameron, 1988:30).

This discussion will begin with Lloyd G. Reynolds' (1982) review of the workings of the simple competitive labour market, followed by a review of the various theories of unemployment, including the different interpretations of the causes of unemployment, and its possible solutions.

## **The Workings of a Simple Competitive Labour Market**

Reynolds (1982) makes the following assumptions about a simple labour market:

1. The attractiveness of a job is measured by its hourly wage rate. Other job conditions are taken as given and constant. The wage is the sole means that the employer can manipulate to attract additional labour.
2. All job vacancies are filled through the market. Internal promotion<sup>1</sup> is ignored.
3. Workers are interchangeable in the eyes of the employer and are equally efficient. Employers' possible preferences based on sex, race, age, experience and workers' difference in efficiency are not to be considered.
4. There are always as many jobs available as there are workers who choose to work at prevailing wage rates.
5. Workers and employers are perfectly informed. That is, workers know about vacancies, wage rates, and job characteristics. Employers know

what workers might be attracted to the firm and what wage it will take to attract them (Reynolds, 1982 p. 60-1).

In a perfect competitive labour market, Reynolds assumes that:

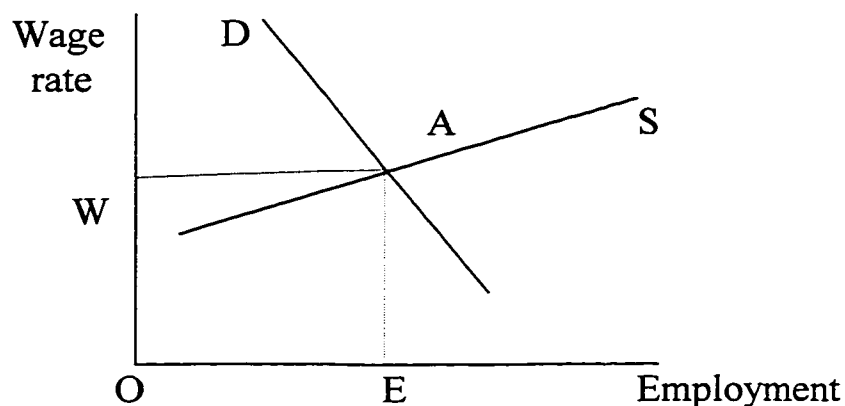
1. There is full freedom of occupational choice. This implies, among other things, that a young person choosing an occupation that requires training can always obtain the necessary funds to undertake training.
2. There is full freedom of exchange. Any employer may hire any worker, and any worker may work for any employer.
3. There are many employers and many workers in the market, so that single actor can influence the market price.
4. There is no collusion on either side of the market. Employers do not unite to drive down the wage level, nor do workers form unions to drive up wages (Reynolds, 1982 p. 70).

Assuming all these conditions, Reynolds applies the model illustrated in figure 2-1, with the demand (D) and supply (S) curves for a particular occupation. It is predicted that the market would move toward equilibrium at point A, where workers E would be employed in this occupation at a wage rate W. Any employer who wishes to hire this type of labour will have to pay

the market wage. Similarly, demand-supply diagrams can be drawn for every type of work performed in the economy.

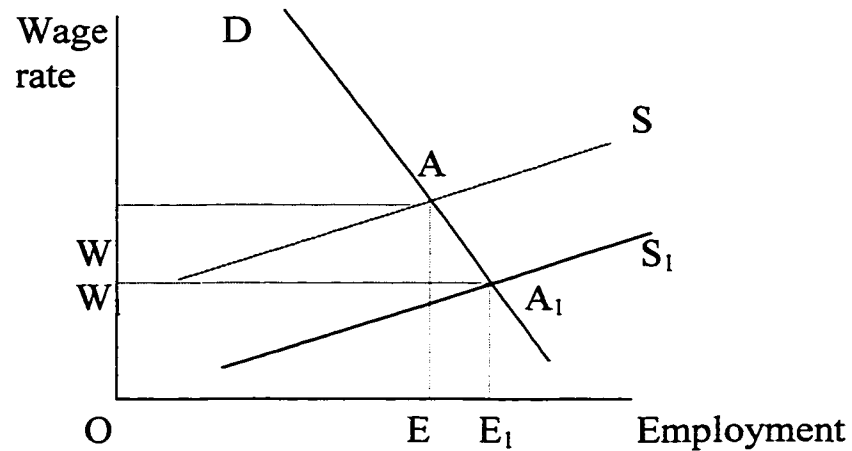
Further to the above mentioned assumptions, Reynolds concluded that the competitive labour markets yield an optimal allocation of the labour force at a specific moment, and that it is an effective mechanism for reallocating the labour force over time in response to the changes in demand and supply conditions.

Figure 2-1 Illustration of the Workings of Supply & Demand in Labour Market



Suppose there is a market where the supply of labour is greater than of demand. The supply curve in figure 2-2 shifts from  $S$  to  $S_1$ . The competition for available jobs drives wages downward to a point where the level of wages causes to attract more workers.

Figure 2-2: Equilibrium in a Competitive Labour Market

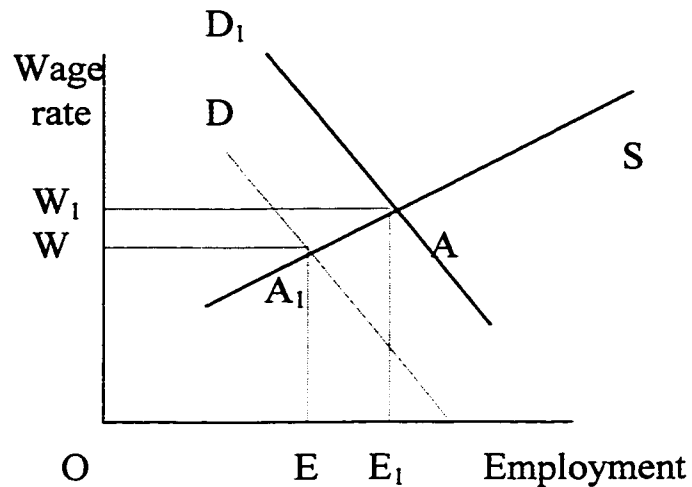


As result of the shift of the supply curve, employment will rise from its original  $E$  level to  $E_1$ , and the relative wage level will fall from  $W$  to  $W_1$ . From here, it is concluded that *increased labour supply to an occupation, where other things remain unchanged, will raise employment and lower the relative wage in that occupation. A decrease in labour supply, on the other hand, will reduce employment and raise relative wages* (see Figure 2-2, Reynolds, 1982:73).

Consider the effects of a shift in demand. Figure 2-3 shows that when the demand of labour rises from  $D$  to  $D_1$ , employment and wage levels both rise. In the case of a decline in labour demand, both employment and wage levels fall (Reynolds, 1982:74).



Figure 2-3: Demand Shifts, Wages and Employment



Therefore, Reynolds concluded that *“increased demand for a particular occupation, other things being equal, will raise both employment and the relative wage in that occupation. A decline in demand will reduce employment and relative wages”* (Reynolds, 1982:73-4).

Under this simple competitive labour market model, wage level is the central variation to the level of unemployment. That is to say, if the demand falls, then a fall in the real wage would clear the market. Unemployment can only be temporary disequilibrium, and it can be solved by a reduction in wages. Therefore, unemployment is simply not a matter of concern in this model.

The labour market in reality, however, isn't as simple as was described above. Starting from the early age of capitalism, the state was brought in to

regulate market deficiencies. Measures such as labour law; minimum wage legislature; unemployment and welfare benefits were introduced to ensure the 'weak' and 'poor' in society could be protected. The development of the union movement and collective bargaining also caused less inflexibility in wage levels (Reynolds, 1982:60-9).

## **Theories of Unemployment**

With the Great Depression in the 1930's and the later development of Keynesian economics, the controversies around the causes of unemployment and the relative role of the state have been fiercely debated. There is little consensus among the various schools of thought. Consequently the remedies to the problem of unemployment often vary from one school to another. For some, this becomes a political issue, a matter of public choice<sup>2</sup>.

### ***The Classical and Neoclassical Explanation:***

According to the classical and neoclassical economists, the workings of the labour market are independent and self-correcting. As it has been concluded in the above section, the fall of the demand curve for labour and the subsequent fall in the real wage to  $W$  would clear the market (see Figure 2-3). The rise of demand will follow a rise in employment and in real wages. Therefore, the classical economists believe that in a market economy the

economic system would spontaneously tend to produce full employment of resources, because the exchange mechanism would ensure a correspondence between supply and demand. Business recessions would cure themselves, with interest rates falling under the pressure of accumulating savings, and this would encourage businesses to borrow and invest more. With wage rates falling, production costs would fall, encouraging businesses to employ more workers.

Therefore, classical economists make the assumption that the labour market is independent. At worst unemployment is only a problem of temporary disequilibrium which can be solved by a reduction in wages. Here, the key factor in the causes of high or massive unemployment would be the real wage level. In the case of a persistent high rate of unemployment, according to the classical theory, wage levels must fall to adjust to the falling of prices of the product market. The causes of unemployment are generally believed to be either state action, such as unemployment insurance act or minimum wage laws, or the “...added strength given to working people’s organisations engaged in wage bargaining ...” (Pigou, 1927 p. 355)

As Cannan (1930) showed long ago, the main effect of unemployment benefits is on the duration of the job search. He suggested that when the

replacement ratio (the ratio of benefits to wages) is high, workers will take longer in searching for a job. Consequently, frictional unemployment, which is generally regarded by classical economists as short-term in nature, becomes relatively longer with unemployment insurance.

“... [T]he (unemployment) insurance scheme has reduced the economic pressure which used to make persons grab at every chance of employment, take what they could get regardless of every inconvenience, and stick to what they had got regardless of every disagreeableness ...” (Cannan, 1930, p. 46-47)

The growing strength in collective bargaining after World War II, deteriorated the competitive nature of the labour market, and made the real wage resistant in the face of the declining competitive position of labour.

The neoclassical economists argue along approximately the same line as the Classicists. They believe that improved unemployment insurance benefits and coverage adversely affect workers' job search behaviour, by increasing the duration of joblessness, reducing labour mobility, and in the end, adding a voluntary nature to some unemployment.

Nevertheless, the classical and neoclassical economists put their faith in the workings of the market. To them, unemployment would not rise unless

somehow the wage level is too high, and above that of the market clearing rate. Government intervention can cause market rigidities, and prevent the market clearing process. Improved unemployment insurance and benefits is positively related to the rise of voluntary unemployment. The workers' collective bargaining power prevents wages from falling to adjust to the falling prices of the product market. These will, in turn, decrease firms' profit margins, to the point where employers are forced to reduce the cost of labour by trimming the size of the work force. Consequently, unemployment increases.

### ***Keynesianism Versus Monetarism:***

#### **Keynesianism**

Keynesian theory is based on Keynes' "*General Theory of Employment, Interest and Money*" published in 1936. The theory disagrees with the classical explanation of the causes of unemployment, and argues that the main cause, or at least a significant part of the cause, is due to the lack of "effective demand" for goods and services workers produce.

In his *General Theory of Employment, Interest and Money* (Keynes, 1936), Keynes argued that consumption depends on the related functions of income and employment. Anticipated expenditure on consumption and

investment is termed as "effective demand". In a situation of equilibrium, Keynes was of the opinion that the level of employment depended on aggregate supply, propensity to consume<sup>3</sup>, and the amount of investment. The level of employment would depend on both the factor of the 'propensity to consume'<sup>4</sup>, and the level of investment. That is, a greater demand for consumer and producer goods leads to an increase in supply. Increasing aggregate supply tends to lead to higher levels of employment.

Because of union pressure to maintain living standards, the difficulty of wage reduction means that rigidity of wages may lead to a situation of equilibrium at less than full employment. Moreover, in the modern economic system, where money exists as the medium of exchange, some money income from supplying goods and services will not always be spent. As a result, the "effective demand" may not always be equal to the supply, creating full employment. Therefore, unemployment to Keynesians has an involuntary nature. If involuntary unemployment is the case, it becomes obvious that part of societal labour resources have been unreasonably wasted, and economic growth is less than it would otherwise be, reducing the welfare of everyone (Tobin, 1974 p. 13). Keynesians, therefore, are concerned with the design of macroeconomic policies to stimulate demands, and restore full employment.

Keynes' theory suggests that in an economic downturn, the government as a buyer of both consumer and producer goods can influence the level of aggregate demand in the economy. Aggregate demand may be increased by fiscal policies or monetary policies. Keynes placed the emphasis on fiscal policy, whereby the government spends more than it collects in taxes. This is known as deficit financing, and it stimulates aggregate demand. Through the multiplier effect, its effects are several times larger, in terms of stimulus to aggregate demand, than the initial expenditure. Thus, the economy moves toward full employment.

It is obvious that Keynesians advocate active government involvement when there is a need. Keynesian theories, therefore, are in direct conflict with classical and neoclassical theories. John Hudson (1988) explicitly concludes that the government can stimulate the economy through three different ways: "First, by increasing their own direct input into the economy; second, by cutting taxes and thus increasing consumer spending power; and finally, the government could, via its control of the money markets, cause interest rates to fall, thus providing a boost to investment. Each of these methods would be supplemented by multiplier effects." (Hudson, 1988:12)

## **Monetarism**

The monetarists counter the Keynesian argument by focusing on changes in the money supply, and its consequential effect on the inflation level. The monetarist believes that inflation occurs when government, for some reason, increases the supply of money (Friedman, 1968 p. 21-39). For Milton Friedman, the effects of government monetary policy are not purely nominal; they can affect the performance of the real economy, including output and employment, but only temporarily:

“There is always a temporary trade-off between inflation and unemployment; there is no permanent trade-off. The temporary trade-off comes not from inflation per se, but from unanticipated inflation, which generally means from a rising rate of inflation. The widespread belief that there is a permanent trade-off is a sophisticated version of the confusion between ‘high’ and ‘rising’ that we all recognise in simpler forms. A rising rate of inflation may reduce unemployment, a high rate will not.” (Friedman, 1968b p. 11)

The monetarists emphasise the balanced relationship between the amount of money available to finance purchases of goods and services, and



the ability of the economy to produce such goods and services. If government spends more than it receives in taxes, in the short run the demand increase from the product market will force the capitalists to raise prices and to hire more employees to meet the demand. However, the increase of aggregate demand will inevitably accelerate the price growth; therefore, the inflation rate will go up.

The monetarists assume that the labour cost to the employers will move up as well, but less than the prices at which the capitalists sell their goods. Monetarists believe this to be because labourers are less efficient than capitalists in monitoring market conditions or they are bound by employment contracts, and forced to accept the same wage in an inflated market.

Consequently, the monetarists argue, unless one is willing to assume that workers are terminally stupid this cannot go on forever. Eventually they realise that their real wages have lagged. When this happens they are likely to negotiate wage increases. The increase claim is likely to compensate for both what they have lost and real wage erosion in the future, based on the current inflation level.

When this happens, the incentive for employers to hire extra labour, as result of government stimulus demand, evaporates. Indeed, the real wage

increases will likely reverse the relationship between employers' profit margin and marginal labour productivity. Therefore, employers begin to lay off workers. Unemployment rises again, at least to the level that it was prior to the stimulus to aggregate demand. The inflation rate will settle at a new and permanently higher level than before the stimulus was introduced. Furthermore, the expectation of inflation will remain at the level it had achieved as a result of the government's demand stimulation.

Supposing the government thought the inflation was too high, and decided to deflate it. The action would make the situation even worse. Demand from product market would diminish, employers would start to cut prices and shrink the production. The profit margin would continue to decline, and employers would begin to lay off more workers. An increase in unemployment would, therefore, prove to be inevitable.

Consequently, the monetarists leave the government little room to intervene in the market, as they believe that it does not have sufficient knowledge of the workings of our economy. Therefore, as concluded by Micheal Smith, the monetarist argument is that: the government stabilisation policies are possible but not usually desirable (Smith, 1992 p.13). To Monetarists, the private decisions in competitive markets normally produce

full employment of resources, including labour. This conclusion is, therefore, very much consistent with the classical and neoclassical arguments.

### **The Rational Expectation Explanation (The New Classical)**

The Monetarists believe that it is possible for the government to exert intervention measures to curb unemployment through fiscal or monetary policies. However, the outcomes can be only short-term, with a underlying assumption being a short-term Philips curve, that the government can employ measures to trade higher inflation rate for low unemployment (Smith, 1992:22).

The Rational Expectation argument went even further on this stand. According to this argument people act rationally. Once they find that their economic welfare is seriously damaged as result of an unanticipated burst of inflation, they will likely devote more time to monitoring prices and adjusting their behaviour to undermine the premises of the policy. Consequently, the improved understanding of the economy can never make any difference. Therefore, according to the rational expectation school, there is not even a short-run Philips curve, and government stimulation measures are just not possible.

## ***Social Corporatism***

Societies such as Austria, Norway, and especially Sweden are generally regarded as the corporatist countries (Milner, 1989:23; Goldthorpe, 1984). A corporatist society, as simply defined by Milner, "is one in which policy is the outcome not of competing interests mediated by the state, but of 'concertation', a 'social partnership' between 'peak' or encompassing representative organisations." (Milner, 1989:23)

Corporatism is hardly considered a distinctive socio-economic system when compared to 'capitalism' (or market) and 'socialism' (or command) economies. The economic institutions and policies carried in corporatist countries are 'mixes' of those of market and command (Milner, 1989:22; Childs, 1936; 1985). The corporatist society comprises a high degree of social consensus among major interest groups, and this enables a more active role of the state. With the fall of a command planning system, the role of state in a corporatist society constitutes the outer limits of capitalism.

As an example of corporatist society, Sweden has by far drawn the most attention, and is considered to be the longest and fullest expression of a corporatist society (Milner, 1989:8). The economic policies practised in Sweden have in fact enhanced the country's ability to adapt to change by

moving economic resources out of declining industries, occupations, and into new ones so as to remain competitive and productive.

Sweden, as a distinctive model, has been associated primarily with union economists Gosta Rehn and Rudolf Meidner. In their 1951 LO (Confederation of Swedish Trade Unions) document entitled "Trade Unions and Full Employment", Rehn and Meidner demonstrated that economic growth built on increased industrial efficiency and competitiveness is the key factor to full employment.

They found that inefficient industries and enterprises tend to survive under inflationary conditions. Therefore, any measures leading to inflation were rejected. First, for example, Keynesian countercyclical policies, according to Rehn and Meidner, inevitably lead to inflation under the new post war world economic conditions (as opposed to the relatively favourable conditions for Keynesian policies in 1930s). They argued that in an 'open' economy, setting in motion an inflationary dynamic brings external factors to bear upon the cost of products. Sooner or later, this undermines full employment (LO, 1951). Second, the trade unions must exercise wage restraint to hold down inflation as economic growth usually leads to high profits and labour shortages, and both factors may result in an increase of

inflation (LO, 1951:92). Third, government should constantly exercise fiscal restraint to keep profit levels sufficiently low, thus to ease the pressure of wage increases. According to Rehn and Meidner, high profits find few incentives and fewer opportunities for significantly increasing employment, and there are limited inducements to improve productivity. Instead, they argued productivity and efficiency can be achieved through labour saving machinery and rationalisation of management.

In general, according to Rehn and Meidner, full employment can only be achieved with continuous, but non-inflationary growth and economic expansion. The key factor contributing to the growth and expansion is the increase of productivity and efficiency at the workplace. These have become the direction for policy design, which consists of three components: the non-inflation requirement, economic expansion/growth, and employment creation.

Based on the unique Swedish socio-political environment, Rehn and Meidner took wage setting as the entry point. They rejected the traditional firm-by-firm wage setting basis, and replaced it with *solidaristic wage policy* based on job nature. They set the wage level high enough to keep firms' profit levels low. As result of these measures, without undermining union solidarity, wage bargaining restraint was practised through the lowering of a firm's profit

prospect<sup>5</sup>. In the meantime price inflation, which might have resulted from steep rises in profit, was avoided.

Meanwhile, with low profits, less competitive enterprises would be forced to shut down. The government was invited to provide 'active' labour market policies<sup>6</sup> to channel the structural unemployed to expanding industries. Such active policies would include measures to enhance job information, counselling and placement service, occupational retraining, reallocation programs and selective employment creation measures.

As result, Swedish industries were forced to adopt innovative measures to improve efficiency and competitiveness, or they would be out of business. The general increase in efficiency and competitiveness of Swedish industries enabled lasting economic growth and overall positive demand of labour.

## **Chapter 3: Labour Market Reform: 1978 - 1994**

According to dogmatic interpretations of Marxism, where a socialist society is established on the basis of public ownership, individuals are the masters of the means of production. Unemployment is considered unacceptable and it is a contradiction of the fundamental spirit of socialism. In the first three decades of communist China (1949-79), various measures were adopted to ensure the individual's "right to work". The most imaginative approach was the so-called "central labour allocation system". Under this system, enterprises were deprived of the power to hire and fire their own employees. A central allocation agency was established, namely the Ministry of Labour and its branch agencies at various levels. Labourers were automatically assigned jobs without considering actual skills and production needs. Jobless individuals were registered as "job seekers" at local employment bureaus, among which 80 to 90 percent were the new school graduates. They were classified as "urban job waiting youth", which means they were ready to be assigned jobs whenever vacancies were available. The mandate of the Ministry of Labour was to assign jobs and ensure that



everyone, no matter whether new labourers or transitional workers, would have a job.

Despite the Ministry of Labour's arbitrary job-assignment power, it remained difficult to provide employment for millions of labourers. To achieve full employment, China split the problem into areas, i.e. rural and urban, and dealt with each separately. A system of "Rural and Urban Household Registration" was set up, and migrations across the nation were discouraged, especially from rural to urban. Then, in the rural areas, a collective farming system, "The People's Commune", was set up. Although underemployment was pervasive, unemployment was claimed to be permanently eliminated. In urban areas, the household registration system effectively controlled the supply of labour on the one hand, and arbitrarily assigned jobs for those jobless labourers on the other. Once the worker was assigned a job, they were guaranteed life employment and benefits, including medical benefits, pension, housing and usually, employment for their children. With these measures, unemployment was soon eliminated.

Yet, full employment achieved through administrative methods has inherited many deficiencies. In the rural areas, the production decisions were passed down from a higher authority and often took no account of the local

conditions. Individuals have no power to decide what to produce, and the prices of products were set and fixed by the central and local planners. Moreover, the prices were usually kept low in order to reduce the cost of industrial input, and thereby generate higher profits. Peasant wages were egalitarian and distribution was based on the participation and income of their communes. The enumeration system showed no reflection of individual productivity. This collective farming system is, therefore, devoid of any incentive to stimulate production.

In urban China, the central labour allocation system caused over-staffing, low production efficiency, poor performance of state-owned enterprises (SOEs) and mismatching of skills and work. In addition, job security and benefits weakened management's authority (Byrd, 1990; Granick, 1990; Jafferson & Rawski, 1992) and the linkage between wages and work performance (Jefferson, Rawski & Zheng, 1992; Solinger, 1991; White, 1987; Kornai, 1991; Hsu, 1991). All these factors worked together to cause general low labour productivity and poor economic performance. Hence, the system required reform.

## **Major Thrusts of Reform:**

### ***Rural De-collectivisation:***

Rural reform was the departure point for China's economic reform. Prior to the reform, agricultural production was organised under "People's Communes" that were further divided into "production brigades" (*shengchan Dadui*) and "production teams" (*shengchan xiaodui*).

Under this organisation, production decisions were passed down from a higher authority and often did not take local conditions into account. The individual peasant was, therefore, deprived of the right to decide what to produce. The production decisions were made by the leaders of the "People's Communes" and products were purchased by the local government, then allocated according to the central plan<sup>1</sup>. The prices of agricultural products were kept low in order to lower the industrial input, thereby, allowing a higher profit margin through industrial production. The peasant enumeration was egalitarian and distribution was based on the participation and the income of the brigade, which did not reflect individual productivity. Even though households were allowed small private plots on which they could produce goods for their own consumption or sale at rural trade fairs, the number and scale of private plots and markets (trade fairs) were strictly

restricted and therefore insufficient to stimulate production. Under such a production system, the agricultural growth in the pre-reform era was barely sufficient to keep up with the population growth<sup>2</sup>.

The reform initiated in late 1979 sought to stimulate production through the introduction of a new “effective incentives” system. To this end, the procurement prices of agricultural products were significantly raised, private plots were enlarged, production diversification and specialisation were encouraged, and the restrictions on rural markets and non-agricultural activities were relaxed. As early as 1977, Zhao Ziyang<sup>3</sup> and Wan Li<sup>4</sup> then the First Party Secretaries of Sichuan and Anhui Provinces, contributed to the design and experiment of a system named later as the “Household Production Responsibility System” (HPRS). The reform became an immediate success in terms of pushing up productivity. In 1983, it was formally endorsed by the reform leadership, and was soon promoted all over rural China.

HPRS reform involved a process of organisational decollectivisation. Under this reform, plots which were formerly collectively owned were made available to households, and a contract drawn between household and individuals and the local government for a fixed period, usually up to 5 years. In 1984, the initial contract period of five years was extended to 15 years for

an annual crop and to 50 years for tree crops. The same contract always included a clause that obliged the household or individual to supply a share of production to the local government as a form of agricultural tax. After the household fulfilled their contractual obligations, they could dispose of the remaining output on the free market, or sell it to the state at negotiated prices (higher than the normal state buying rate). The essence of the system was to increase the private margin of agricultural production, and therefore the incentive to the individual<sup>5</sup>.

Along with the HPRS, the government increased by 25 percent the buying rate of agricultural products. All these measures effectively motivated individuals' production efforts. From 1978 to 1979, the agriculture output had grown 7,5 percent. In the following five years, agricultural growth continued (see Table 3-1).

***Table 3-1. The Growth of Gross Output Value of Agriculture, 1978-92. (in percent)***

	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92
Growth Rate	8.1	7.5	1.4	5.8	11.3	7.8	12.3	3.4	3.4	5.8	3.9	3.1	7.6	3.7	6.4

*Source: Statistical Yearbook of China 1993, T 9-7, p. 336.*

### ***The Emergence of Rural Industry:***

One of the most important outcomes of the agricultural reform was the unexpected boom in Township and Village Enterprises (TVEs). As

restrictions affecting nonagricultural activities were progressively rolled back, rural enterprises sprang up absorbing surplus rural labour and contributing to rising foreign exchange earnings (see Table 3-2 and 3-3). From the start, TVEs were allowed to retain profits and achieved significant productivity gains through reinvested earnings. In addition, they were initially given tax reduction treatment, supplemented by access to credit from the rural credit cooperatives. One notable departure from the past was the freedom granted to TVEs to sell their products at market prices. Another was the change in the wage system. Previously, wages were paid to production teams and were then distributed to individual members of the team. The newly emerged TVEs shifted to a more direct and performance oriented wage system, which greatly improved individual incentives and productivity (White, 1987).

The key to the early success of the TVEs was based mostly on the extent to which market forces were allowed to sculpt their development, rather than to ownership change. Most TVEs are still owned by the collectives.

First, the supervising government agency had every incentive to ensure the success of the enterprise, since it was one of their sources of revenue.

Second, the TVEs faced a hard budget constraint<sup>6</sup>. The townships did not have the resources to support failing enterprises, and the banks were similarly disinclined to extend credit in the absence of government financing. Moreover, unlike the state-owned enterprises (SOEs), TVEs had to capture markets for their products or inputs. Indeed, during the initial period of the rectification program in 1988-91, bank credit to TVEs was largely suspended, and many of them closed causing considerable loss of employment (White, 1987).

Third, they were not obliged to provide social support services to the same extent as were the SOEs. From the beginning, TVEs were allowed to adjust their employment according to their production needs, and also to determine their wage levels accordingly. They operated in a purely competitive labour market environment without any institutional interventions such as minimum wage, unionism, etc.

Fourth, the TVEs were created in an environment where commodities were in relative shortage. This situation increased the market accessibility for the TVEs' products. Moreover, compared with the bureaucratic management of the SOEs, the organization of TVEs was very flexible, and they could adjust quickly to the response of the market (World Bank, 1991).

**Table 3-2: Source of Employment Growth by Type of Enterprise and by Sector, 1985-1991**

Type of enterprise	Growth in employment (thousand)	Share in growth of total employment (percentage)
State owned	20,270	19.9
Urban collective	4,120	4.1
Urban private	4,210	4.1
Foreign-owned	1,790	1.8
Total rural	71,250	70.1
Rural collective & private	43,951	(43.2)
Rural farm*	27,300	(26.9)
Total	101,630	100.0

Source: *Statistical Yearbook of China, 1992, pp. 97 and 389.*

Note: \* Calculated as the difference between the rural workforce and the total employment of rural enterprises.

**Table 3-3: Exports of Non-state Owned Rural Enterprises, 1985-1992:**

Exports (billions of dollars)	1985	1986	1987	1988	1989	1990	1991	1992
Total Exports (billions dollars)	1.2	2.7	4.4	8.0	10.0	13.0	15.0	20.0
Share of total exports (%)	4.4	8.7	11.2	16.8	19.0	20.1	20.9	23.0

	1986-1992	1989-1992
Share of Total Export Growth (percent)	32.6	32.0

Source: World Economic Survey 1993, World Bank, p. 197.



**Table 3-4. Share of Industrial Output by Type of Enterprise, 1980 - 1991**  
(Output in Current Price)

Type of enterprise	80	83	84	85	88	89	90	91	92
State-owned	76.0	73.0	69.0	65.0	57.0	56.0	55.0	53.0	48.1
Non-state-owned	24.0	27.0	31.0	35.0	43.0	45.0	45.0	47.0	51.9
Collective-owned	24.0	26.0	30.	32.0	36.0	36.0	36.0	36.0	38.0
Urban	..	..	..	15.0	15.0	14.0	14.0	13.0	11.5
Rural (TVEs)	..	..	..	15.0	19.0	20.0	20.0	21.0	24.2
Joint urban-rural	..	..	..	2.0	2.0	2.0	2.0	2.0	2.3
Individual-owned	0.0	0.1	0.2	1.8	4.4	4.8	5.3	5.7	6.7
Urban	..	..	..	0.3	0.4	0.4	0.4	0.5	0.5
Rural	..	..	..	1.5	4.0	4.4	4.9	5.2	6.2
Foreign-owned	0.5	0.8	1.0	1.2	2.7	3.4	4.4	5.7	7.11

Source: *Statistical Yearbook of China 1993, Calculation Based on T10-1, p. 409.*

The rapid growth of TVEs has led to a dramatic change in the economic landscape, particularly in the countryside, where there were estimated to be a total of about 19 million TVEs employing more than 100 million workers out of a rural labour force of about 430 million in 1992.<sup>7</sup> It is estimated that TVEs contributed to half the rural GDP and accounted for about one-third of farm income. In 1992, the gross value of industrial output of TVEs was estimated to be about one-third of the country's total (see Table 3-4).

### ***Urban Labour Market Reforms:***

As mentioned above, the old labour system guaranteed employment and allowed job tenure for all "staff and workers"<sup>8</sup> in both SOEs and large collective enterprises (then called "big collectives," or "*Dajiti*") which had

been effectively incorporated into the state sector through the “commercial nationalisation movement” since the late 1950’s<sup>9</sup>. In 1983, 96.8 percent of the state workforce were “fixed workers” (guding gong)<sup>10</sup>. In other words, they were tenured workers who had the right to remain in their initial enterprise for life (White, 1985). The enterprises were obliged to provide welfare benefits to all their employees, which includes medical insurance, housing, child-care, pensions and in many cases employment for workers’ children<sup>11</sup>. This system, therefore, resulted in a stable workforce, with virtually no labour flow between industries or even enterprises. This situation was reinforced by centrally controlled job assignments, which resulted in overstaffing in almost all SOEs and, in Kornai’s words, “unemployment on the job” (Kornai, 1986).

### **The Debate on Labour Market Reform:**

In the early 1980’s, Feng Lanrui of the China Academy of Social Sciences termed guaranteed life employment as the “iron rice-bowl”, and accused it as the major impediment to raising productivity and efficiency (Feng, 1980). Feng Lanrui also pointed out that the goals of higher labour productivity and full employment were not contradictory in general, and argued that growth in labour productivity will not hamper employment but create conditions for employment. She said: “we cannot merely think of the

present or adopt the method of sacrificing labour productivity to solve the employment problem, for in the end this will hamper a solution to the employment problem instead.”

Feng’s argument was reinforced by the debate on the “current situation” in early 80’s. In 1981, Suing Qidong and Sun Keliang from the State Planning Commission published an article in the authoritative party magazine *Hongqi* (Red Flag), arguing that the unemployment situation was manageable, and that productivity oriented reforms in the labour system should be emphasised. Meanwhile, some provincial governments phased out programs designed to combat unemployment, and directed their attention to the issue of labour productivity<sup>12</sup>.

Early in 1982, Zhao Lukuan, a well-known professor at the People’s University in Beijing identified the contract labour system as an effective way to deal with the “iron rice-bowl.” According to Zhao’s argument, employment relation between employer and employee should be defined with clear terms and conditions in a contract agreement. Violations of contract will naturally lead to the termination of contract. As a result, employers will be empowered with management authority, and employees will also be able to choose jobs according to wage, workload and working conditions, etc.

Zhao's view was echoed by the reform leader Zhao Shouyi who had experimented with labour reform in his province of Anhui, and was later appointed Minister of Labour and Personnel in May 1982. Zhao's reform unfolded in late 1982, when he identified 28 small- and medium-sized cities that were succeeding in eradicating urban unemployment, and therefore seeking to switch the public focus from unemployment to productivity. He encouraged practical experiments with reforms to the labour and wage system, and expressed special interest in the labour contract reform where the terms and conditions of employment between the enterprises and the workers were specified. The contract labour system was first tried in Shengzhen, one of China's first "Special Economic Zones". The reform proved to be extremely successful in promoting labour productivity<sup>13</sup>.

By the late 1980's, the debate seemed to have reached a consensus that the command labour allocation system had to be reformed, and the new system would emphasise efficiency. Various views were extended, most of which fell into the four following camps:

In the first camp were the radicals, who wished to clear away ideological taboos and accelerate the pace of reform. They were particularly uncomfortable with the "iron rice-bowl" and its consequences; they expressed

their support for establishing a labour market system, and argued that the state should no longer expect to maintain full employment. They thus favoured a rapid universalisation of the labour contract for all workers and cadres in the state sector (Wei Jie, 1985; Xiao Liang, 1985; Luo Ruigang, 1985; Liang Tianming, 1986; Gao Shangquan; 1994).

The second argument was represented by the reform vision of the Ministry of Labour and Personnel. They also criticised the “iron rice-bowl” and called for the universalisation of the labour contract system, but with a more gradual approach.

The third argument saw some merit to the fixed status of workers under the socialist system. However, they recognised that the labour contract reform was a way to raise labour productivity. They believed that a mixed system of both fixed and contracted labour was a more appropriate arrangement than either an all fixed or all contracted labour system. An example of these views is provided by Cheng Jizhong of the Sichuan Provincial Labour Bureau who argued at the Ministry of Labour & Personnel’s 1986 symposium on labour contracts, that the “iron rice bowl” is a big problem, however, it is a different issue with the fixed labour system. The contract labour system may not solve all the problems. There are other “social factors” which account for low

productivity, such as hereditary employment<sup>14</sup>, training practices and managerial deficiencies. Cheng argued that the “iron rice bowl” does contribute to the low productivity, but that it is not the only factor; indeed, there are more important causal factors than simply the fixed labour system. After all, the Japanese practice life employment<sup>15</sup>, and have achieved admirable productivity. Furthermore, life employment in fact increases workers’ loyalty to the firm (Cheng Jizhong, 1987).

The fourth reformist view was represented by Jiang Yiwei, a noted economist and former head of the Institute of Industrial Economics of the China Academy of Social Sciences. Jiang supported the idea of a contract labour system, but opposed the idea of its universalisation. In Jiang’s opinion, the economic reform had been bringing about a shift of power within the enterprises in favour of management, and the universalisation of a labour contract system would intensify this trend. In his words, workers would become “hired labourers” instead of “masters”. Jiang proposed a three-tier system of fixed, contract and temporary workers which would achieve greater labour flexibility<sup>16</sup>.

## **The Labour Market Reform Measures:**

In the early stages, the labour market reform did not take any concrete form. The reform measures were focused more on reducing day-to-day state interventions and increasing channels of employment. These measures can be summarised as the following: 1. the reduction of state administrative controls, and the introduction of elements of a market mechanism; 2. the diversification of employment channels, through encouraging the operation of “labour service companies” and labour exchanges operating outside the formal network of state labour administration (White, 1987); 3. improving the incentive system, by introducing a management responsibility system and bonus system for employees; 4. empowering SOE management by permitting managers to hire, discipline and dismiss workers<sup>17</sup>; 5. changing the employment status of SOE workers from virtual job tenure to one based on specific contract terms (White, 1993).

In the early 1980's, contract labour gradually gained popularity as a tool to aid low labour productivity. Starting from 1982, the Ministry of Labour and Personnel, then headed by reformist Zhao Shouyi, launched various labour contract experiments within different parts of China. Unsurprisingly, each experimental site reported significant increases in labour

productivity as opposed to sites with fixed workers. Inspired by the initial success, Zhao published a long article in the industrial newspaper, *Workers Daily*, in which he argued that labour reforms should be accelerated. He identified himself, by name, with two main architects of reform: the Party General Secretary, Hu Yaobang, and the State Premier, Zhao Ziyang. Zhao also warned of “stubborn resistance” to the reforms and the danger of flaccidity among leading cadres charged with implementing them<sup>18</sup>.

On February 22 1983, the Ministry of Labour and Personnel issued a formal circular calling “to experiment actively with the labour contract system.”<sup>19</sup> The Ministry condemned the old system as “significantly defective”:

“Under such a system, some people may comfortably depend on the enterprises and the state and eat from the “big pot”; they take the fruit of other people’s work without contributing or while contributing less. This system suppresses the enthusiasm and creativity of the industrious; many useful people are unable to contribute. This system in fact functions to suppress progress and protect backwardness, significantly



handicapping the development of productive forces. It therefore must be reformed.”

It called for ‘active’ experimentation with the recruitment of new workers based on labour contracts. It also set some general rules about experiments with contract labour. It stated that the labour contract system should be introduced in state enterprises and in collective enterprises at the level of county and prefecture, that is, collective enterprises that for all practical purposes are run like state enterprises (and usually directed by state cadres). The system should apply to both ordinary workers and all categories of technicians. The duration of the contract terms can be as short as one year or as long as twenty years. The contracts should include provisions for the rights and duties of both parties, such as: the nature of the work, duration of the contract, probation time, pay, social insurance, labour protection, conditions of termination and changes of contracts, and liability for the violation of contracts.

The introduction of the labour contract system was part of the intention to “smash the ‘iron rice-bowl’ ”. However, the labour contract reform was still only at the “partial” and “experimental” stage. There was considerable

vagueness, leaving a good deal of room for evasion or “creative implementation.” For example, the length of contracts could be either long or short, and only applied to new workers, while the established workforce retained their “fixed” status. Although the ministry declared that eventually the contract system would apply to all workers, no timetable was announced. These short-comings, as we shall see later, turned out to be a major problem during the policy implementation.<sup>20</sup>

In 1986 the State Council issued another four “Temporary Regulations.”<sup>21</sup> These four “Temporary Regulations” set out the guidelines for recruitment, termination of contracts, employment benefits and other issues.

The main elements of the labour contract were as follows:

1. The contract is drawn up between worker and enterprise, and formally approved by the local state labour bureau. The contract specifies the duration of the agreement, the responsibilities, powers and benefits of the respective parties, including wages, fringe benefits, labour insurance, nature of the work and required productivity standards, and

the terms for renewal or cancellation. The contract length can vary from two or three years to as much as twenty years.

2. Some of the peripheral responsibilities previously held by enterprises (such as providing housing and day-care centres) have been handed over to private businesses or government sponsored organisations outside the firms. It was hoped that this would allow enterprises to concentrate on production. Employees no longer rely solely on their employers for such benefits.
3. Renewal of the contract depends on the worker's performance as well as on management policy. If a manager decides to let a worker go, or if a worker decides to leave voluntarily, the state agency can give him/her some temporary financial assistance and help him/her find another job.

### **Enterprises Reform & Bankruptcy Law:**

Another major thrust of reform was the introduction of the Bankruptcy Law in 1987. Since the late 1970's and early 1980's, Chinese reformers progressively accepted and promoted market competition as an integral part of the market mechanism to spur enterprise efficiency (Rider and Knell, 1992; Har and Moore, 1990; Hsu, 1991). Attention had also been

placed on the legal and informational requirements for market competition. In 1986, the first Chinese Bankruptcy Law was introduced. It showed the reformers' determination to accept the consequences of competition.

However, as many have noted, the number of bankruptcies was extremely limited. It is clear that, despite the desire to establish a competitive industrial restructuring, the Chinese policy-makers had intentionally controlled the pace toward their goal<sup>22</sup>.

In the late 1980's, the performance of state-owned enterprises (SOEs) continued to deteriorate. As table 3-5 shows, in the late half of the 1980's, the proportion of loss-making SOEs continued to grow, and accounted for 31.5 percent of the total in 1990. Meanwhile, the net pretax profit of SOEs continued its declining trend.

***Table 3-5: Performance of Industrial SOEs in Central Budget***

	1985	1988	1989	1990
Proportion of Loss-making SOEs	10.7	12.2	16.3	31.5
Net Pretax Profit as % of Revenue	23.8	18.7	15.8	10.4
Retained Profit as % of Net Profit	18.3	18.5	16.7	15.3

Source: China Statistical Abstract, 1992 p. 87.

The issue of industrial restructuring, especially of SOEs, is a complex one, since it involves negative impacts on existing employment and the

individual's welfare. The long practice of job assignment, life employment and security had made SOEs similar to local welfare agencies.

In 1992, the Economic and Trade Office of China threatened to declare 2,000 bankruptcies for those SOEs making continuous losses. Compared to the enormous number of loss-making SOEs, the 2,000 bankruptcies was quite limited. However, this number has never been reached. According to China's official Xinhua News agency, in the past years there have only been 160 enterprises nationwide who have begun legal proceedings for bankruptcy, with over 90 going bankrupt. These numbers are extremely limited when considering that there are 104,000 SOEs, and about 40 percent of them are in the red with another 30 percent are teetering on the verge of losses<sup>23</sup>.

The problem is the fear of massive unemployment, and the consequential social and political unrest. The bankruptcy case of Harbin Knitting and Textile Co., for example, has involved 100,000 jobs and \$7.2 million in losses in a single shot. China had not yet established a comprehensive system of social security, including old-age pensions, medical care schemes and unemployment insurance to absorb the casualties.

Therefore, the policy-makers chose a “go-slow” approach, and looked for other possible alternatives. In an interview with Hong Kong’s three Beijing-backed newspapers, Li Peng, the Chinese Premier, said China would not liquidate loss-making firms the ‘capitalist way’ with massive closures, bankruptcies and layoffs<sup>24</sup>. Instead, Li argued: “For the sake of the workers and administrative staff, we should try to have unsuccessful enterprises shift to a different line of production or merge with others, rather than suspending operations or closing down.”<sup>25</sup>

In summary, the one and half decades of reform have sought to transform the Chinese command system to a market system. The reform of the labour system has not yet rendered a competitive labour market system. However, the reform has a profound impact. The number of unemployed has gone up significantly. In addition, labour surpluses in rural areas and urban underemployment are problems that remain unsolved. In chapter 4, I shall examine the consequences of China’s labour market reform.

## **Chapter 4: The Consequences of Government Labour Market Reform: Unemployment Versus Underemployment**

Before China's installation of a socialist central planning system, the urban unemployment stood at 13.2 percent of the urban labour force in 1952 (or 3.766 million people)<sup>1</sup>. With the establishment of a central labour allocation system, the unemployed were soon assigned jobs in the state industries and collective farms. In the late 1950's, China declared its achievement of the socialist ideal: full employment, throughout the country. In the following two decades, China employed various measures to maintain full employment. However, it is by no means an easy task to guarantee jobs for all. In 1979, the urban unemployment had gone up again and stood at 13 percent<sup>2</sup> (or 15 million people).

At the time, it was not taken as open unemployment, and was termed "urban job waiting youth". The Chinese government continued the exercise of labour allocation. With the economic reforms, urban unemployment gradually became a problem of concern. In 1995, the official statistics recognised 2.9 percent urban unemployment, which was expected to grow in the years to come. However, this low official rate of unemployment contradicts the general concern of the problem of unemployment. In fact, the true figures of unemployment often believed to be much higher.

The purpose of this chapter, is to first, evaluate the inherited short-coming in the calculation of the official unemployment rate; second, to estimate the true extent of the problem of unemployment; and third, to analyse the causes and the nature of the problem of unemployment.

### **Population, Labour Force and Participation Rate**

China has the largest population in the world. The July 1<sup>st</sup>, 1990 census revealed that China has a population of 1,118,162,727. This number accounted for about one-fifth of the world total, and was five times that of the US population, and nine times that of Japan (Table 4-1). Despite China's efforts to control the growth of its population, the population growth remains at a rate of 1.4 %, lower than that of low-income countries, but much higher than that of any high-income countries (Table 4-1).

**Table 4-1: China's Population and Population Density in Comparison**

	Population (millions)	Land Area (1,000 Km <sup>2</sup> )	Population Density (persons/km <sup>2</sup> )
China	1,162.2	9,561	122
Poland	38.4	313	123
Japan	124.5	378	329
Canada	27.4	9,976	3
USA	255.4	9,373	27

Source: World Development Report, 1994, pp. 162-3.

A large population can be a valuable economic resource, but it also requires the economy to provide the jobs and materials necessary for an



adequate standard of living. One indicator of the economic burden of population is population density. When there is limited land per person, productive activities are under restraint to some extent. China's population density of 112 persons for every square kilometre is not very high when compared with Japan (329) and South Korea (429). However much of China's population is concentrated in the eastern part, especially along coastal areas. In Shanghai, for example, the population density reached 20,000 persons per square km (Statistical Yearbook of China 1993). Thus Shanghai's population density is close to three times that of Tokyo.

**Table 4-2: China's Labour Force Participation Rate in Comparison**

	1973			1980		
	Labour Force Participation Rate (%)			Labour Force Participation Rate (%)		
	Total	Male	Female	Total	Male	Female
China	65.4			77.2*		69.5*
Japan	71.7	90.1	54.0	71.8	89.1	54.9
Sweden	75.5	88.1	62.6	81.0	87.8	74.1
UK	72.9	92.7	53.3	73.5	89.3	57.6
USA	68.4	86.2	51.1	72.4	85.4	59.7

Source: ILO, World Labour Report 1-2, Oxford University Press, 1987, p. 47.

Note: \* Data of 1987.

The concept of 'labour force' refers to "the total number of people in an economy in paid employment or available for work (i.e. the total number of people in employment plus the number of unemployed)." (Bannock, Baxter and Davis, 1992:248) The standard international practice is to regard

those who are between 15-65 years old as being in the productive age group. Using this criterion, China's productive population is 760 million<sup>3</sup>.

The "labour force participation rate" refers to "the proportion [of the population] aged 15-65, who gainfully employed or are seeking gainful employment (i.e. in the labour force)" (Bannock, Baxter and Davis, 1992:323). China's labour force participation rate is 65.4 percent (1993), and it is high compared with other countries (but it is lower than these: 71.8 percent in Japan [1980], 72.4 percent in the US [1980], 73.5 percent in the UK [1980] and 65.4 percent in the former West Germany [1980]). Women's participation rate in China is extremely high, and accounts for 69.5 percent, higher than Japan's 54.9 percent, the US's 59.7 percent, and the UK's 57.6 percent (ILO, 1987).

## **The Labour Market**

According to the neoclassical economic theory, the proper functioning of the labour market requires wage levels to be determined according to the demand, and differentiated according to level of education, skill, and job performance. However, under the command system, wage level is arbitrarily set according to a central plan. There are virtually no income differences among members of society. The government puts more emphasis on socialist values, such as jobs for all and distribution equality.

Efficiency and productivity are a less urgent issue under the command socialist system.

The labour reform, on the other hand, aimed to increase efficiency and productivity through the introduction of a market mechanism. As result of the reform, a dual labour system was created. For the TVEs and urban collective & private sector, a labour market system was generally applied. For the state owned sector, where in the past years, the state sought to introduce more market mechanism to the old labour command allocation system, however, many large SOEs remain protected under the command system.

The central labour allocation system was dismantled. Various market reform measures had been tried. Fearing massive unemployment and possible social unrest, the Chinese reformers had been cautious about the restructuring of China's large inefficient SOEs. Consequently, underemployment and low labour productivity remained the major problems of the SOEs. The Bankruptcy Law was introduced, yet seldom exercised, especially with the large- and medium-sized SOEs. As a result, employment at these SOEs was protected, but the cost was the steady increase of state subsidies (see Table 4-3).

In the non-state sector (mainly the TVEs, private enterprises in both rural and urban areas and enterprises with foreign ownership), a comprehensive labour market system was established. The enterprises of the non-state sector are generally free to hire or to dismiss workers according to their need. The wage level can be freely set according to general market principles. The union is still subordinate to the communist party, and has no real power to influence wage levels. There is no state legislation on minimum wage. There is not even a national unemployment insurance program or social welfare system. It is a labour market at its most competitive form.

**Table 4-3: SOEs' Operating Losses and the State Subsidies**

Year	SOEs Operating Losses (billions, Yuan)	As Percentage of GNP (%)
1978	3.6	1.0
1980	3.4	0.8
1983	10.3	1.8
1985	18.0	2.1
1986	32.5	3.4
1987	37.5	3.3
1988	44.6	3.2
1989	59.9	3.8
1990	57.9	3.3
1991	50.6	2.6

Source: Ministry of Finance and the World Bank Country Study 1992, table 7.4.

## **Open Unemployment**

As a result of China's labour market reforms, open unemployment has reemerged. In 1986, China's first unemployment insurance scheme was introduced. However, the scheme was limited to the urban areas. It allowed those registered openly unemployed workers to receive an insurance fund based on 60-75 percent of the total the average standard wage<sup>4</sup> for the first 12 months of unemployment and up to 50 percent of their standard wage for the following 12 months (Korzec, 1994).

China's official statistics revealed an extremely low rate of unemployment (less than 3 percent from 1983 to 1995). Among the unemployed, young graduates from various levels of educational institutions account for more than 80 percent of the total (see Table 4-4).

From the data indicated in Table 4.4, it is easy to notice two main features of China's unemployment situation. First, China has a low unemployment rate, less than 3 percent for most of the 1980's and 1990's. With 3 percent unemployment, many would agree that it is indeed full employment with a relatively tight labour market. The second feature is the high proportion of youth unemployment. The statistics reveal that about 80 percent of the openly unemployed are new graduates from various levels of institutions. This category of unemployment is defined in the West as

*frictional unemployment*, and is usually considered to be only temporary and therefore does not cause major concern.

**Table 4-4: Urban Unemployed and the Rate of Unemployment (millions)**

Year	Unemployed Persons (million)	Percentage of Youth* Unemployment	Unemployment Rate
1978	5.300	47.0	5.3
1980	5.415	70.6	4.9
1981	4.395	78.0	3.8
1982	3.794	77.4	3.2
1983	2.714	81.8	2.3
1984	2.357	83.1	1.9
1985	2.385	82.6	1.8
1986	2.644	79.2	2.0
1987	2.766	85.0	2.0
1988	2.962	82.8	2.0
1989	3.779	81.8	2.6
1990	3.832	81.6	2.5
1991	3.522	81.9	2.3
1992	3.603	83.2	2.3
1993	--	--	2.7**
1994	--	--	2.8**
1995	4.803**	--	2.9**

Source: Statistical Yearbook of China 1993, p. 119, 4-23

Note: \* Includes persons aged 16 to 25;

\*\* Data quoted from Reuters report (by Chalmers, John. *China's Urban Unemployment May Hit 7.4 percent in 2,000*, 01-12-1996) on the unemployment forecast from China's Ministry of Labour.

The above findings creates a paradox where, on the one hand, Chinese official statistics indicate that there is no unemployment problem, while on the other, unemployment has always been seen as China's major social problem. Even the Chinese government ranked unemployment as one

of the two top concerns of the country<sup>5</sup>. This paradox challenges directly the validity of China's official rates of unemployment.

To understand the problem, we shall first look at how “unemployment” and “the rate of unemployment” was defined and calculated. According to the China Statistics Bureau, “the *number of urban unemployed* refers to those able-bodied urban residents aged 16 to 50 for male and 45 for female, who are looking for employment, and registered at the local labour bureau”. Furthermore, “the *rate of unemployment* represents the number of unemployed persons expressed as a percentage of the total urban social labour force.”<sup>6</sup>

In the West, the unemployed refers to the “section of the labour force able and willing to work, but unable to find gainful employment” and the rate of unemployment “is measured as the percentage of the total labour force out of work.”<sup>7</sup> Statistics Canada defines the “unemployment rate” as: “the number of unemployed persons expressed as a percentage of the labour force,” where the labour force “is composed of those members of the civilian non-institutional population 15 years of age and over who, during the reference week, were employed or unemployed.”<sup>8</sup>

First, it is obvious by definition that China’s rate of unemployment refers to only the urban unemployment rate. The rural unemployed is

excluded from the calculation of the official rate of unemployment. Even the rural migrants who are currently residing in urban cities, usually considered illegal, are excluded from the official rate of unemployment.

Second, “the urban social labour force” refers to urban labourers aged between 16 to 50 for males and 16 to 45 for females. Persons aged 15 and those above the cut-off age (50 for male and 45 for female) are all excluded. Therefore, a portion of unemployment which would be calculated in the West is not calculated in the Chinese rate of unemployment.”

Third, the Chinese statistics only consider the *registered* unemployed persons. Since China’s unemployment benefit scheme was only intended to provide unemployment benefits to a limited number of cases<sup>9</sup>, it is not surprising that the unregistered unemployed workers are excluded from the official calculation.

It can be concluded, therefore that the Chinese rate of unemployment is not comparable to the rate of unemployment calculated in the West. One thing which is clear, however, is that the Chinese official rate of unemployment has by far under-estimated the real situation.

The low official rate of unemployment also indicates that the loss making SOEs remain protected from shedding unnecessary employment and that bankruptcies are still limited. Otherwise, the registered unemployment



as a result of shedding unnecessary labour and closures of loss-making SOEs would most likely increase, in turn increasing the unemployment rate itself.

### **The Un-registered Unemployment and Underemployment**

Because the official statistics don't reveal the real problem of unemployment, in past years there have been various estimates about the level of unemployment. Gao Shangquan from People's University in Beijing, estimated that among the 400 million rural labourers, some 50% are surplus labourers. In other words, 200 million rural labourers are unable to find either farm jobs or jobs from rural industrial firms. They are indeed unemployed but not registered and therefore excluded from China's official unemployment statistics. Gao also expects that "the figure will keep growing at an average annual rate of 10 million, and is estimated to reach 250 million by 2000." In the urban areas, Gao expects 8 million new job market entrants to be added each year. By the year 2000, an additional 60 million will be added to the total urban labour force (Gao Shangquan, 1995). Furthermore, Gao estimates that 10 million workers in the SOEs are underemployed.

Even though the Ministry of Labour continuously stated that the urban unemployment rate was 2.9% or 4.8 million toward the end of 1994,

they did agree that there were about 100 million rural surplus labourers. This estimate is half of that estimated by Gao, yet, it remains high by any standard.<sup>10</sup> Meanwhile, the Ministry of Labour reported that in 1993, there were 20 million rural unemployed labourers moving to the cities and towns, and seeking various types of jobs. The number rose to 25 million in 1994 and 30 million in 1995.<sup>11</sup> This trend was expected to grow annually (Beijing Review, 1995). In addition, a survey conducted by the Ministry of Labour indicated that SOEs nation-wide have over 10 million redundant workers, which constitutes 12% of the total work force in the state sector (Wu Nantao, 1995).

A recent survey by the International Labour Organisation suggests that China's urban labour surplus is 18%, more than the total unemployed and underemployed in SOEs (Economist, 1995b).

**Table 4-5: Labour and Employment Under Eighth Five-year Plan (millions)<sup>12</sup>**

	1990
<b>Total Employed Labour Force</b>	570
Urban	150
Rural	420
<b>Surplus Labour</b>	164
Urban Unemployed	4
Urban Underemployed	20
Rural Surplus labour	140

Source: China State Planning Commission. (cited from *China: Reform and the Role of the Plan in the 1990s*, p. 96-7.)

The World Bank cites the State Planning Commission that, in 1990, rural underemployment is estimated at about 140 million and that of urban areas at 20 million (Table 4-5).

As we can see the estimates regarding unemployment and underemployment are varied. It is indeed a difficult task for any individuals or organisations apart from China's official statistics office to provide precise estimates on unemployment. For now, however, it is clear that the official rate of unemployment far under-estimates the true problem.

In summary, as a result of the market-drive reform, the former socialist conditions of full employment with high underemployment ceases to exist. In its place are the mixed problems of open unemployment, unregistered unemployment and underemployment. In the rural areas, there is a huge reserve of surplus labour, and it is estimated to range from 100 million (as estimated by the Ministry of Labour) to 200 million (as estimated by Gao).

## **The Nature and Causes of Unemployment**

Under a proper market system the causes of unemployment can be simply classified into two major categories: cyclical causes, i.e., unemployment due to inadequate aggregate demand; and non-cyclical

causes, or those linked to demographic, structural, institutional or other factors (Sharp, Voyer and Camcron, 1988:30).

Keynesians assume that the market is inherently unstable, and therefore unemployment has its cyclical causes. They emphasise the involuntary nature of unemployment, and argue that the government should take action to stimulate aggregate demand, or else the problem of unemployment is not likely to disappear by itself. The mainstream economists (mainly neoclassicals) emphasise the structural and institutional “rigidities” as the main causes of unemployment. They argue that external factors (such as excessive government intervention or unrestrained union wage bargaining power) are the main causes of improper wage mechanism. Under the market system with free fluctuations of wage levels, unemployment should only be a temporary problem and short term in nature. Government intervention in the market can only cause further complication of the problem. Therefore, to the mainstream economists, the solution to the problem of unemployment is to deregulate the market, and to leave the market as free as possible.

In the case of China, as a result of the latest market reform, a dual labour system combining of both market and semi-command mechanisms was created. The non-state sector operates under a free and competitive

labour market system. The firms are free to hire or to fire workers according to their needs. Wages are paid according to the general market principles, and the state and union has no effect on general wage setting. The firms are completely accountable for their own profits and loses. Efficient firms expand rapidly, and have become the primary source of employment. The inefficient firms face the consequences of bankruptcy. In the past reform era, the non-state sector had evolved to be the most dynamic sector. It expanded rapidly, and served as the primary source of employment. However, the employment generated through the expansion of the non-state economy is still far from enough to achieve full employment for the enormous labour force.

In the state sector, the central labour allocation system was dismantled. SOEs are free to hire workers according to their needs. However, the underemployed workers are still allowed to exist for the purpose of protecting employment. Inefficient firms, especially large- and medium-sized ones, are allowed to operate at the expense of state subsidies. Consequently, SOEs not only serve as a production unit but also function in part as the local welfare agency.

Further market reform requires a functional change, and the establishment of SOEs as efficient production units. This transition will

inevitably involve measures to eliminate underemployment, and bankruptcies of inefficient SOEs. In the past years, many reform attempts have been made in China and elsewhere. The Chinese reform, however, is cautious and slow, in the face of possible widespread unemployment. This caution is entirely understandable. Over 100 million people are employed by state firms and perhaps a quarter of the population is dependent on people employed by SOEs. Employees usually obtain not just their pay, but their housing and health benefits through their work units. Morton (1996:33) estimates that as many as 30-40 percent of the SOEs' work force might lose their jobs if they were forced to operate on strictly commercial lines.

In the past reform era, China has refused to close down or sell off loss-making SOEs. Instead, China's strategy has been to let the dynamism of the private sector gradually reduce the significance of the state share of the economy. Consequently, China has avoided a high rate of unemployment and economic recessions, and has achieved relatively high growth rates. The question is, will China's economic growth be sustainable without seriously reforming the SOEs?

Many economists argue that the state enterprise system still needs radical reforms. They believe that SOEs continue to swallow a huge share of the country's resources. According to the World Bank data (World Bank,

1993), about 70% of China's industrial workers are still employed by the state. The number of people employed in the state sector has actually risen by 20% since 1985. Furthermore, SOEs accounted for 70% of industrial investment in 1993, up from 61% four years earlier. While SOEs gobble up money, private companies are groaning about a credit crunch. Subsidies to the SOEs are also widely believed to be the main force that drives up inflation, which hit 27% in 1994. Attempts to restrict the money supply and to cut subsidies to SOEs mean that unpaid debts pile up across the economy and then hurt private industry.

Problems like these have convinced many people that SOE reform in China is getting more urgent. The reform of SOEs is daunting and unprecedented. Similar reforms which took place in East European countries have shown significant increases in unemployment, combined with heavy production decline. In the case of China, the situation could be even worse. Many East European countries, before entering economic reform, had a tight labour market, whereas China has been constantly fighting unemployment with more extensive and articulated measures. The Chinese government seems sure of the direction in which it wants to go, however, the question is how to get there.

In the following chapter, I shall examine two alternatives. Each is developed on different economic theories, and applied in a different economic context. Consequently the results differ significantly.



## **Chapter 5: The Role of State and the Problem of Unemployment**

As it has been described in Chapter 2, the economic theories present distinct views toward the relationship between the state and the problem of unemployment. For many economists (i.e. the classical, monetarist, new classical or rational expectationists and neoclassical), the market is the fundamental force that determines the factors of distribution. It is believed that a competitive market with little state intervention is efficient, and it has the tendency towards the full employment of all available resources, including labour (Hudson, 1988; Tobin, 1974).

Keynesians argue otherwise. Their arguments focus around what Keynes terms "effective demand". They believe that, in the modern economic system where money exists as the medium of exchange, some income from supplying goods and services will not always be spent. As a result, the effective demand may not always equal the supply, resulting in less than full employment. Therefore, Keynesians argue that in today's dynamic economy, government policies of demand management are an important factor in maintaining full employment, especially at the time of economic downturns.

The Swedish corporatists agree that government policies have a role to play, but they disagree with Keynesians' macro stimulation measures. They believe that government fiscal stimulation measures will inevitably create government budget deficits and increase inflation pressure. Instead, Swedish corporatists tend to design government policies based on general agreement among major interest groups and aimed at increasing industrial competitiveness through a process of accelerated restructuring. However, the corporatist foresees that these policies will inevitably create problems such as frictional unemployment. Therefore, included in their recommended government intervention measures are also measures, now called "active policies", to remedy the negative consequences.

This chapter examines two political economic models – the Polish 'shock therapy', and the Swedish corporatist approach. They are distinctly different in many obvious aspects. However, they also share some similarities. Despite the differences in the scale and depth, both of the examined models are designed to achieve industrial efficiency and competitiveness through restructuring. However, they each follow distinctive paths to achieve their goals.

The Polish government took a firm market stance by imposing large-scale privatisation measures – the selling off of public enterprises to private

agents. It is presumed, according to Jeffrey Sachs, the inventor and chief supporter of shock therapy approach, that "... the private owners will do a better job of saving the viable parts of industry and sloughing off the unviable parts." (Jeffrey Sachs, 1991:208). Meanwhile, according to the shock therapist's explanation, once the market system is established, the market incentive creates pressure for production increases, which then result in an increase in demand for labour, ultimately leading to full employment. The shock therapist believes that government should distance itself from the workings of the market. In fact state involvement can only cause market rigidities, which is usually the major cause of unemployment.

The Swedish government, on the other hand, has been actively involved in the economy through implementing a set of sectorial industrial policies, aimed at increasing efficiency and competitiveness. The Swedish government not only employs traditional monetary and fiscal policies, but also "active" labour market policies, for example, job training programs, job information centres, etc. to deal with structural unemployment resulting from industrial restructuring.

This chapter provides a review of these two distinctive models with the focus on governments' roles in dealing with structural changes, and also

on the outcome of restructuring in terms of the level of unemployment, production, etc.

### **The Search of Market: The Polish Model**

Similar to what has been done in China, the last Polish communist government had initiated reform programs as early as December 13, 1981. The reforms focused mainly on the enterprise level, with measures such as the increase of enterprise autonomy, macro discipline, and later, the introduction of worker's self-management.

However, the reforms were later considered unsuccessful. As explained by Janos Kornai (1980; 1990), the communist's reform was neither a planned nor a market economy. It was a bureaucratic co-ordination simulating some market behaviour traits without any gains in overall efficiency. In particular, enterprise budget constraints remained 'soft'.

Finally, in 1989, massive subsidies had led to a large budget deficit in the first half of the year, and resulted in hyperinflation of 315 percent toward the end of 1989 (United Nations Economic Commission for Europe). External debts increased rapidly, and reached \$40 billion by 1989, which significantly eroded external credibility (Gomulka, 1993:189).

When the first non-communist government, headed by Mazowiecki, came to power in 1989, the economy was in a deep crisis. The state sector

consisted of more than eight thousand enterprises and accounted for more than 82 percent of GDP and 87 percent of total employment (if excluding agriculture). Many SOEs were operated at the expense of state subsidies. Triggered by the massive subsidies, inflation went up more than 300 percent.

Polish SOEs shared the same characteristics of all former socialist centrally planned economies. Inputs were allocated according to the central plan, full employment was a goal to central planners, and managers were rewarded for achieving production targets rather than earning profits. Productivity was never a concern, employment levels were fixed. The managers' power could be secured by simply fulfilling the set production targets. If the cost of production was not a concern, they preferred to have more workers at their disposal rather than too few.

Furthermore, the banking system was tightly controlled by the government. There was a monobank that oversaw all credits in the economy. Its goal was to ensure that credit was allocated in support of the economic plan<sup>1</sup>.

Under this system output was generally of poor quality, and there was little innovation. Therefore, Polish products had little international competitiveness, and were far below the Western European Standard.

New leadership and their advisors from the West, advocated a total transformation of the political economic system. A radical reform approach was taken, and the aim of the plan, according to Jeffrey Sachs, was the " ... introduction of market forces that will guide most of the needed restructuring." The reform must proceed as rapidly as possible, because "such an approach vastly cuts the uncertainties facing the public with regard to the new 'rules of the game' in the economy." Sachs uses wit to describe the approach: " ... if the British were to shift from left-hand-side driving to right-hand-side driving, should they do it gradually ... say, by just shifting the trucks over to the other side in the first round?" (Sachs, 1991:198-9).

The proposed transformation plan had been welcomed by the general population. As polls indicated, in 1982-1988 some 60-80% of adults were in favour of introducing the laws of the market and free competition (Kolarsk-Bobinska, 1990:163). The 1989 crisis served, and in part, triggered the option of the radical reform approach. It was expected that the transformation would not be easy, however, many people, and even some of the experts, were not fully aware of the costs. Instead, it was generally expected that this transformation would lead to a rapid improvement in the standard of living.

## **The Balcerowicz Plan**

On January 1, 1990, the new government implemented the macroeconomic transformation program. It is widely known as the Balcerowicz Plan, after the name of the Finance Minister of that time. They proposed three main types of policies, i.e, economic liberalisation, macroeconomic stabilisation and privatisation of the SOEs.

Measures such as the introduction of all necessary legal frameworks for the creation of new private property and the introduction of market competition, serve as the major part of liberalisation policies. Macroeconomic stabilisation involves measures to limit budget deficits, reduce the growth of the money supply, and establish realistic and uniform exchange rates, in order to create a working monetary system based on a convertible currency and stable prices. Privatisation includes various measures introduced for the purpose of selling or simply giving away those inefficient SOEs.

### **Economic Liberalisation and Macroeconomic Stabilisation:**

In order to end the hyperinflation, the government decided to sharply devalue the zloty and defend it at the internal rate of exchange of 9,500 to the US dollar, the black market rate of the time. Forcing prices to adjust to its level, this nominal measure proved to be effective in beating

hyperinflation. By the end of 1990, inflation had dropped to 250 percent, to 50 percent one year later, and to 30 percent by 1993 (see table 6.1) (V. Samonis and C. Hunyadi, 1993:4).

**Table 5-1: Estimates of the Rate of Unemployment and the Rate of Inflation in Post-communist Poland**

	Unemployment %	Inflation %
1990	1	250
1991	7	70
1992	15	50
1993	20	30

Source: Compilations, estimates and forecasts by Valdas Samonis and Csilla Hunyadi based on data from different sources including central statistical offices of Poland and Hungary, The Economist and Morgan Stanley Research.

Moreover, by Spring of 1990, the multiple exchange rates of the zloty, i.e. the official tourist rate and black market rate, etc. had disappeared, yielding a single rate. The supply of zlotys and credit was tightened, and a high interest rate was introduced to increase the stability of zloty. However, the tightened government budget, especially the large government cuts on various forms of subsidies, resulted in sudden increases in unemployment. According to the data collected by Samonis and Hunyadi, the unemployment rate had consistently gone up, and reached 20 percent by the end of 1993 (see table 6.1).

The reform had also instituted a strengthened social safety net to minimise the consequences of social disruption. In 1991, the first Social



Security Act was enacted. However, as it was later discovered, by World Bank economists the sharp decline in subsidies (especially to SOEs) had been matched by an equally sharp increase in cash benefits to the population. These cash benefits included unemployment benefits and heavy pension outlays, as the state has absorbed most of the costs of the transformation (World Bank, 1994:X).

### **Privatisation and the Reform of SOEs**

Most policymakers, including advisers from the West such as Jeffrey Sachs and David Lipton, viewed privatisation as a necessary condition to increase Polish industrial competitiveness<sup>2</sup>. This privatisation in a broad sense included two parts, according to Sachs (1991:198). First, the growth of new private firms as a result of the economic liberalisation; second, the privatisation of existing state property.

It was hoped that the new private ownership would create the necessary incentives to revitalise companies with prospects of open international competition in the new environment. And, of course, the process of privatisation would also provide the means to eliminate unpromising companies. The ultimate goal of privatisation, as it was pointed out by Sachs (1991:208), is to restructure the Polish economy for international competition.

Motivated by popular support, Poland instituted a Privatisation Law on July 13<sup>th</sup>, 1990. In August 1990 the Polish government formed The Ministry of Privatisation (MPW). The main purpose of the MPW a) to propose a variety of privatisation policies, b) to promote investment necessary for the purpose of privatisation from abroad, c) to monitor the privatisation process, d) to co-ordinate between trade unions, management and the chamber of commerce, and e) to train new management in the fields of privatisation and securities market.

The July 13, 1990 Privatisation Law set a goal to privatise 50 percent of all state firms in the period of 1991-95. The Privatisation Law made a few exceptions in the area of the defence industry, and national assets such as coal mining, energy supplies and transport infrastructure, etc. The Law allowed for two fundamental and alternative methods of privatisation. The first was called "commercialisation" followed by public sale, while the second was "liquidation" followed by private sale.

“Commercialisation” involves the transformation of state firms into state treasury corporations (either as joint-stock or limited liability companies) with the shares then being sold to private investors. The MPW appoints an adviser, and the adviser then prepares the financial and legal audits, and information package. When investor(s) express interest, the firm

can be sold in part or whole at the highest bid. "Liquidation" is not like the liquidation forced by bankruptcy. Usually the subject company is in relatively good financial condition and there are good prospects of finding private interest in purchasing or leasing all or part of the company.

As the privatisation continued, there were many other forms of radical approaches discussed. Also considered was a program called "Mass Privatisation Program (MPP)" (virtually a simple transference of shares at zero prices to all Polish citizens above a specified minimum age), which was parliamentary approved in April 1993. However, the radical transformation program gradually lost its popular support. Disputes in parliament and among many political leaders made the implementation of MPP extremely difficult (Lewandowski, 1995:94-5).

### **The Corporatist Swedish Model**

Perhaps there has been no other government in the world that has been so committed to the scheme of full employment as the Swedish government (with exceptions of former communist governments, and Italy & Germany prior to the World War II). The Swedish government has long been known for its innovative labour market policies that aimed to achieve full employment. Public labour exchange institutions in Sweden can be traced back as early as the beginning of this century. In the 1920's

vocational training programs for the unemployed were introduced (Milner, 1989:102). However, these economic policies with regard to the labour market had been pushed to their extreme in the two decades after World War II. These policies had been somewhat successful, and over the years the unique Swedish economic system (social democracy) has been generally referred as the "Swedish Model" (Shenfield, 1980; Schwartz, 1980), or "the middle way" (Childs, 1961:86). People praise the Swedish economic system such as "the progress machine" (Jenkins, 1969:27), "the prototype of a modern society" (Tomasson, 1970) and so on.

The Swedish government went far beyond the limits of a classical economist. Swedish policy-makers rejected Keynesian forms of stimulation policies. Instead, they put strong emphasis on policies that support and promote development which measured efficiency in industry (LO, 1951:23-4).

The Swedish Model was associated primarily with the LO (Confederation of Swedish Trade Unions: Landsorganisationen I Sverige) economists Gosta Rehn and Rudolf Meidner. It is therefore known as the "Rehn-Meidner Model". Although Rehn and Meidner were indeed unionists, it did not prevent them from realising that the trade union movement should not merely be aimed at wage bargaining, as this will

cause wage-push inflation, and in the long run, will hamper total productivity and make it difficult to maintain full employment (LO, 1951:82). Moreover, Rehn and Meidner know that full employment will inevitably lead to labour shortages. Consequently, inflation would rise. Therefore, anti-inflation mechanisms have to be built into the very process of growth and full employment<sup>3</sup> (LO, 1951:92).

It is a unique model that was designed to assume continual restructuring and adjustment, consequently to serve the interests of production efficiency, international competitiveness, economic growth, low inflation and full employment. Government was the main actor who launched the policies developed on the basis of general consensus among the unified labour union and employer's association.

According to the summary of Horvath and Daly (1989:26), the main ingredients of the Swedish model are:

- a tight fiscal policy;
- non-intervention in the production of goods. Free market forces were allowed to shape Sweden's industrial base, and ownership of industry remained in private hands;
- a "solidaristic" wage policy to reduce wage differentials so as to achieve greater equality and improve labour mobility;

- an active labour market policy of tackling unemployment, with measures like recruitment subsidies and job-creation schemes, and improvement of the mobility of labour by providing retraining, relocation grants for workers, and information services to make job vacancies known (Horvath and Daly, 1989:26).

The key point of the Swedish model is the “solidaristic” wage policy. It is this policy that the Swedish government employed to trigger constant economic restructuring. The point of the policy is to narrow wage differentials. This is in direct conflict with the norm of classical and neo-classical economics.

According to the ‘solidaristic’ wage policy, the labour union insisted on the ‘same work, same pay’ principle despite the company’s profitability. Consequently this made it difficult for the inefficient firms to survive. Meanwhile, the very same wage policy eased the wage pressure for profitable firms, and made more resources available for them to make further expansion. With the tight government fiscal policy, the firms or industries with low profitability did not get any support. Thus, the process of industrial restructuring proceeded with the accelerated bankruptcies of inefficient firms and resource re-allocation to expanding firms or sectors.

The Swedish government understood that structural unemployment would be unavoidable with the process of accelerated restructuring. To be consistent with the restructuring, the Swedish government introduced a set of labour market policies, known as the “Active Labour Market Policies” (ALMPs) to assist the unemployed to find new employment in the expanding sectors. All of these aimed at ensuring full employment.

The ALMPs mainly focused on three areas. First, employment services were improved to reduce frictional unemployment by eliminating informational obstacles. The job vacancies were made more efficiently available to those looking for jobs, and the unemployed were also given the necessary advice and assistance with job searches. Second, the unemployed were also offered training to improve skills to fit job requirements. Third, massive government subsidies were aimed at the creation of temporary relief jobs and re-allocation subsidies were provided to improve labour mobility.

In the following chapter I shall examine the consequences of the Polish and Swedish restructuring models.

## **Chapter 6. The Polish and Swedish Models Compared**

### **The Consequences of Poland's Economic Transition**

The results of the Polish transition were mixed. On the positive side, the tightened monetary and fiscal policies brought hyperinflation under control (see table 6-1). Even though the rate of price increases continued its growth trend through 1992, confidence in the zolty was established and maintained, and its internal convertibility at a unified rate was been preserved. Moreover, as result of economic liberalisation, Poland now enjoys more quality goods and services from the West. The internal reserves have increased substantially, and a fifth of the total international debt has been cancelled with the prospect of a further fifth of the debt being cancelled within the next three years (Charles, 1992:A9). Perhaps the most remarkable achievement is the establishment of a market economic system and the disappearance of the command economic system. These were also accompanied by democratic distribution of political power.

However, the radical transition program has also proved costly. The most significant costs have been the length and depth of the recession (lasting for more than three years, from 1990 to 93). The signs of recession can be measured by three different aspects: 1. the rapid drop in industrial



production and GDP; 2. a significant increase in the level of unemployment; and 3. general public resentment of the program of transition.

**Table 6-1. Poland's Main Economic Indicators 1988-1991**  
(annual rates in percent)

	1988	1989	1990	1991	1992	1993	1994	1995
GDP Growth (annual % change)	4.4	0.2	-11.6	-27.7	-9.7	11.0	7.4	6.0
Industrial Output (annual rate in %)	5.3	-0.5	-23.3	-14.2	..	..	..	..
Rate of Inflation	59.0	244.1	584.7	70.3	43	35	32	27.8
Gross Fixed Investment (%)	5.4	-2.4	-10.0	-8.0	..	..	..	..

Source: Economic Bulletin for Europe ECE, New York: United Nations; Economic Survey of Europe 1990-1991, New York: ECE,. United Nations. Economic Policy Forms, World Bank, 1997

In 1990, the first year of the introduction of transition programs, the GDP fell by 11.6 percent. It was followed by another 27.7 percent drop in 1991. Industrial output also dropped by 23.3 percent in 1990 (see Table 6-1 below). The drop in the GDP and the decline of industrial production was also accompanied by a spectacular growth of inflation in Poland. In 1990, the annual rate of inflation went as high as 584.7 percent, and it was followed by another 70.3 percent in 1991.

Unemployment was among the most perplexing problems. As Table 6-2 indicates, from the beginning of the shock treatment, unemployment went up steadily. It started from 1.5 percent of the total labour force and

rose to 16.7 percent in the three years following the shock treatment implementation (see Table 6-2).

**Table 6-2. Unemployment Indicators**

	Unemployed in percent of Labour Force	Registered Unemployed (1,000)	Unemployed as a result of Mass-layoffs (1,000)	Percent of School Graduates	Percent of University Graduates
Mar. 90	1.5	266.6	15.1	..	..
Jun. 90	3.2	568.2	58.1	..	..
Sept. 90	5.2	926.4	126.4	..	..
Dec. 90	6.3	1,126.1	183.1	14.6	0.8
Mar. 91	7.3	1,322.1	250.5	11.6	0.6
June 91	8.6	1,574.1	315.3	9.2	0.4
Sept. 91	10.7	1,970.9	422.1	11.9	0.5
Dec. 91	11.8	2,155.6	498.0	10.3	0.5
Mar. 92	12.1	2,216.4	539.5	9.0	0.4
June 92	12.6	2,296.7	565.6	6.6	0.3
Sept. 92	13.6	2,498.5	606.7	8.3	0.4
Dec. 92	13.6	2,509.3	603.6	7.4	0.4
Mar. 93	14.4	2,648.7	608.2	6.6	0.3
June 93	14.8	2,701.8	585.9	5.5	0.2
Sept. 93	15.4	2,830.0	569.7	8.3	0.3
Dec. 93	15.7	2,889.6	562.4	7.1	0.3
Mar. 94	16.7	2,950.1	550.3	..	..
June 94	16.6	2,933.0	484.2	..	..

Source: World Bank, Poland: Policies for Growth with Equity, 1994:102.

However, one interesting finding is that the number of unemployed caused by mass lay-offs was surprisingly low, and accounted for only 23 percent of the total unemployment which was mainly caused by the reduction of the redundancy of SOEs. The lack of mass lay-offs meant that bankruptcies were still rather exceptional and no major restructuring took

place in the industrial sector. Changes in industrial employment levels were limited, and did not correlate with fluctuations in industrial output. This therefore confirms the relative inflexibility of employment from SOEs (Rosati, 1993:214).

Two years after the implementation of transition programs, the industrial output fell by a cumulative 35 percent in 1992. Unemployment reached 2.5 million people at the end of 1992, or 13.6 percent of the total Polish labour force. Toward the end of 1993, the number of unemployed had reached 2.93 million, 11 times the number of people unemployed when the transition began in early 1990.

Investment expenditures in 1992 declined 4.1 percent in real terms as compared to 1990. Private consumption declined by 15 percent in real terms in 1990. Real wages declined by 8 percent, and individual farmers' income dropped by 39 percent.

All these negative consequences added to a general dissatisfaction, and finally it undermined the political and social consensus on the transition program. Before the implementation of shock treatment, polls showed that 60-80% of adults in the period from 1982 to 1988 were in favour of market transformation. However, in the course of the reforms, popular support for the radical reform plan declined steadily, from about 45 percent in favour

and only 10 percent against in October 1989, to about 20 percent in favour and 40 percent against in October 1991 (OBOS, BS 457, November 1991).

In November 1990, the first post-communist government was voted out of office by a convincing majority. This election was widely seen as a referendum on the effectiveness of the governing body and in particular on its economic policy. In fact, since the fall of communism in 1989, governments have changed frequently in Poland, but fortunately all Polish cabinets, including the current one composed of ex-communists, have hewn firmly to the line of economic reform first laid down by Balcerowicz (McKinsey, September 97).

Seven years after the shock treatment, the Polish economy began to reveal some strength. Starting in 1992, Poland reversed the economic decline, growth gradually increased in the 5 years after 1992, and GDP growth averaged at about 5 percent per annum. Starting in 1997, the value of goods and services produced in the economy has been above pre-1989 levels, marking a dramatic recovery from the initial shock. In 1996, the country's private sector accounted for 60 percent of the GDP.

Of course, problems remain. Particularly troubling are the persistent inflation rates of 27 percent in 1995 and 14.6 percent in 1996, and an unemployment rate of more than 12 percent in 1996. The Polish government

estimates that more than half of Poles live in poverty, with less than \$170 a month per person, which is considered the minimum necessity.

However, according to Balcerowicz, the first Post communist Finance Minister, the worst is over. Harvard economist Jeffrey Sachs estimates that at the current pace of economic growth, in a matter of 23 years, Poles should reach 90 percent of the average income of EU citizens "... What we need is years and years of very high economic growth, not just two or three years, and not just 5 percent." (McKinsey, 1997)

### **The Consequences of the Swedish Active Labour Market Policy**

By the same criteria (e.g. inflation, unemployment and production), the Swedish economy performed extremely well over the years between the 50's and the 80's. Unemployment was low, despite the relatively high and inflexible wages (the norm of neoclassical economics theory). The Swedish model shares the same ethic as the market system, with strong emphasis on growth through efficient markets for goods, capital, and labour.

What distinguishes the Swedish model is the significant role that the Swedish government played in the making of a strong economy based on the co-operative relationship between management, workers and the government. In contrast to the more market driven approaches elsewhere, especially in the US, the Swedish government exerted extensive

interventionist measures to ensure the efficiency of the economy on the one hand, and full employment on the other. The 'Solidaristic' wage policy limited the number of inefficient firms and industries. The creation of an employment fund secured funding for the development and support of efficient enterprises. The bankruptcies of the inefficient firms or industries made available the necessary resources and labour for the development of the expanding sector.

Furthermore, the Swedish government spent generously on programs called 'Active Labour Market Policies' (ALMPs) to ensure the flow of labour from declining industry to expanding industry. Among these ALMPs, the employment services were considered the most cost efficient one (Blanchflower D., R. Jackman & G. Saint-Paul, 1995:96-8). Meanwhile, other ALMPs, such as government sponsored training and re-training program, especially the job creation programs were more controversial. On the one hand, these programs were charged for their high costs and often questionable results<sup>1</sup> (Blanchflower D., R. Jackman & G. Saint-Paul, 1995:98-108); On the other hand, they were praised for their capability to hold short term unemployment level low, consequently, they fulfilled the objective of economic stabilisation<sup>2</sup> (Ohlsson, Henry, 1995:29-53). Compared to many other advanced industrialised countries (see also

Chapter 5), the Swedish government restricted direct unemployment compensation, which is generally considered to be a 'passive measure'.

**Table 6-3. Expenditure on Labour Market Programs (LMPs) per Unemployed Person (in US)**

Country	Year	Total Cost of LMPs (in US)	Cost of ALMPs (in US)	Expenditure on Active Measures per One Unemployed Person as Percentage of Total LMPs Expenditure LMPs <sup>II</sup>
Canada	89-90	9,974	2,434	24.4
France	1990	14,766	4,400	29.8
Sweden	1991	31,026	18,863	60.8
United Kingdom	1991	5,468	1,865	34.1
United States	89-90	4,710	1,780	37.0
OECD Average <sup>I</sup>		13,000	5,036	38.7
Poland	1990	624	200	32.0
	1991	769	54	7.0
	1992	711	33	4.7
	1993	642	71	11.1

Source: OECD Employment Outlook, July 1994, and Ministry of Labour and Social Policy.

- I. Unweighted calculation on data from countries including Austria, Belgium, Denmark, Finland, Germany, Greece, Italy, Netherlands, Norway, Portugal, Spain, Switzerland and Turkey, in approximate the same time period.
- II. Net expenditure (without taxes and charges) on active programs included training of unemployed persons, subsidised employment, public works and loans for creation of small enterprises.

Table 6-3 demonstrates clearly that the resource allocations to ALMPs were significantly higher than other OECD countries. More than 60 percent of total expenditure was allocated to ALMPs, whereas the OECD average is only 38.7 percent. Moreover, the Swedish labour market program

is also the most expensive one as compared to the other OECD countries. The average level of public expenditure per unemployed person in the OECD area was US \$13,000, compared to the Sweden amount of US \$31,026, almost three times more. Poland spends significant amounts of limited resources on 'passive' measures, and a very small percentage on ALMPs. In 1990, 32 percent of labour market expenditure was allocated to ALMPs, which followed with only 7 percent in 1991, and 4 percent in 1992. There has been some increase in the expenditure on ALMPs since 1993, but the percentage remains far lower than OECD average.

**Table 6-4. Expenditure on Labour Market Policy as Percentage of GNP, Share of Active and Passive LMP Measures in the OECD Countries, 1985 - 1991.**

Country	Total	Active Measures	Passive Measures	Percentage of Active Measures
Canada	2.38	0.57	1.81	24
France	2.03	0.76	1.27	37
Sweden	2.69	1.87	0.82	70
United Kingdom	2.14	0.72	1.42	34
United States	0.75	0.25	0.50	33
Average*	2.29	0.81	1.45	37

Source: Excerpted from Table 4.11 from Johannesson, J. and Wadensjo, E. eds. *Labour Market Policy at the Crossroads*. Ministry of Labour, Stockholm, 1995:94.

\* Author's own calculations from the source table.

In addition, Table 6-4 shows that the Swedish government spent a very similar amount in terms of the percentage of GNP on labour market programs<sup>3</sup>. However, what distinguishes Swedish expenditure on the labour



market program is its spending pattern, particularly the heavy expenditure on ALMPs.

**Table 6-5. Internal Migration in Comparison, 1970-1987 (%).**

Year	Canada	France	Sweden	UK	USA
1970	1,9	..	..	..	3,6
1971	1,9	..	..	..	3,4
1972	1,8	..	..	..	..
1973	1,8	..	4,8	..	..
1974	2,0	..	4,9	..	..
1975	1,8	..	4,8	1,2	..
1976	1,6	..	4,5	..	3,0
1977	1,7	..	4,0	1,0	..
1978	1,7	..	3,7	..	..
1979	1,7	..	3,9	1,2	..
1980	1,7	..	4,0	..	..
1981	1,8	..	3,5	1,1	2,8
1982	1,8	..	3,4	..	3,0
1983	1,5	..	3,4	0,9	2,7
1984	1,6	1,4	3,7	1,1	2,8
1985	1,5	1,2	3,9	1,2	3,0
1986	1,5	1,3	4,0	1,1	3,0
1987	1,5	1,3	3,9	..	2,8

Source: Excerpted from The OECD Jobs Study, Part II, Table 6.4.

As result of the unique formation of the Swedish model of development, and the contribution of Swedish ALMPs, Swedes were revealed to be a more movable labour force as compared to other industrialised countries. Table 6-5 provides information on the mobility of individuals across regions. For example, in 1987, 3.9% of Swedes moved, as compared to 2.8% in the US, 2.6% in Norway and 1.1% in Germany. The

higher rate of regional mobility suggests that the Swedish system was effective at reallocating workers.

In more than three decades, the Swedish rates of unemployment were kept significantly lower than any of the other industrialised countries. Starting from the early 60's to the late 80's and early 90's, the Swedish rates of unemployment were kept at around 2 percent. In other words, there was full employment throughout the three decades, since 2-3 percent of unemployment is considered to be a healthy and necessary lubricant to the dynamic economy.

**Table 6-6. Unemployment Rates in OECD Countries, 1960-1991**  
(period average as percent)

Countries	1960-73	1974-79	1980-85	1986-91
Canada	5.0	7.2	9.9	8.6
France	2.0	4.4	8.3	9.8
Sweden	1.5	1.5	2.4	1.9
United Kingdom	2.9	5.1	10.5	8.8
United States	4.8	6.7	8.0	5.9
Average*	2.1	4.0	6.9	7.0

Source: Excerpted from Table 4.2 in Johannesson, J. and Wadensjo, E. eds. *Labour Market Policy at the Crossroads*. Ministry of Labour, Stockholm, 1995:94.

\* Author's own calculations from the source table.

Meanwhile, the performances of Sweden's economy and industry were extremely high despite the constant changes of the economic and industrial structure. For the period 1870-1976, the GNP per capital grew

rapidly and steadily in Sweden. The country's industrial productivity was among the highest in the industrialised world. Furthermore, the strength of economic and industrial growth was far more stable, with fewer and smaller cyclical fluctuations around its underlying growth trend (see table 6-7).

**Table 6-7. Economic and Industrial Development in Comparison, 1870-1976**

Country	GNP	GNP per capita	Industrial Production (average annual percentage change)
France	2.0	1.8	2.6
Sweden	3.0	2.5	4.1
United Kingdom	2.9	1.5	2.4
United States	3.6	2.0	3.9

Source: Excerpted from Table 2.1, Horvath, Dezso, and Donald, J. Daly, *Small Countries in the World Economy: The Case of Sweden: What Canada Can Learn From the Swedish Experience*. Halifax, N.S.: Institute For Research on Public Policy, c1989.

In recent years, however, the once glorious Swedish Model has become increasingly problematic. In 1989, 61,000 Swedes or 1.4 percent of the Swedish labour force were unemployed. By the first quarter of 1993 the numbers had risen to 313,000 or 7.3 percent of the labour force. In addition, another 290,000 Swedes were participants of labour market programs (Blanchflower, D., Jackman, R., Saint-Paul, G., 1995:11-2).

Furthermore, in the early 1990's, the Swedish industrial output fell along with the decline in employment. The increasing cost of the highly generous welfare system resulted in a corresponding rise in the fiscal deficit.

Spending on labour market programs alone in 1993 to 1994 rose to 5.7 percent of the GDP compared with 2.9 percent in Norway, 1.75 percent in the UK and 0.69 percent in the USA. With the deepening of this crisis in early 1990's, the operation of the Swedish social programs became impossible.

There are many different explanations of the current crises of the Swedish Model. According to the government failure theory, the fall of the Swedish Model is closely associated with the failure of the government intervention policies. This argument rests on the assumption that there are clear disadvantages to governments intervening in the economy. First, the government may face informational constraints in making the right, and more importantly, timely, decisions. The previous decades of central planning practices provide important lessons for this issue. Second, even if the decisions are right and also made in a timely manner (which is indeed idealistic), it may not be efficient. The investment in information collection and processing may itself increase the cost of input. Third, once a decision on policy is in practice, the government will face the task of monitoring the workings of the policy and the reaction of the market. The question is whether in comparison to the private sector, the government has the advantage in collecting, analysing and eventually effectively monitoring the

market reaction. The practice and spectacular fall of the communists' central planning system in the past does not provide much support for continued government intervention in the economy.

In his study of the Swedish case, Blanchflower found that government intervention in the market was large and comprehensive, starting with wage formation, to the regulations (legislation) in the labour market such as hiring and firing provisions, and the social security and ALMPs (Blanchflower, D. G., Jackman, R. and Saint-Paul, G., 1995:45). However, the question is whether it is necessary for governments to extend such extensive intervention. In his study, Blanchflower found that there are few market failures which can justify government intervention to such a degree.

Moreover, according to Blanchflower and his associates, the ALMPs contributed to the Swedish aggregate level of employment (Blanchflower, D. G., Jackman, R. and Saint-Paul, G., 1995:43). According to the OECD (1994), the employment and participation rates in Sweden are high. The female participation rate particularly is as much as 10 points above many other rich industrialised countries, such as Norway, Canada, and the US. However, given the complexity of employment management and those clear disadvantages for the government mentioned above (i.e. the informational

constraints, and the monitoring of the outcome of the implementation of certain government intervention measures), they found that the traditional tools such as fiscal and monetary policies are more reliable in their outcomes than labour market policies, even though the latter might be more immediately effective in their employment effects (Blanchflower, D. G., Jackman, R. and Saint-Paul, G., 1995:63).

Blanchflower and his associates found that some labour market policies are more cost efficient, such as employment services (especially the improved job matching system). Other policies such as job training and direct job creation programs are less impressive relative to their cost (Blanchflower, D. G., Jackman, R. and Saint-Paul, G., 1995:96-102). Therefore, it was argued that the ALMPs deserved further study and should be implemented in a discriminative manner.

Furthermore, some economic theorists argued that the fall of the Swedish Model is a result of failure to adjust and adapt to the growing integrated world economic ties. This trend combined with the rigid Swedish interventionist approach severely limited the ability of Swedish government, acting individually, to maintain full employment and deliver their part of the neo-corporatist social contract (Streeck, Wolfgang, 1993). As a result, the Swedish industries became less competitive and efficient (Lindbeck, Assar,

1994:77-89, Chapter 3). It made the Swedish Model fundamentally betrayed from the original design of continuing restructuring and adjustment, to meet the goal of achieving higher production efficiency, international competitiveness.

The situation was escalated by the growing competition forced upon Swedish industry through the global economic trade ties from low labour cost countries, especially newly industrialised countries in South East Asia (Edward E. Leamer and Per Lundborg, 1997:399-464). As a small export oriented country like Sweden heavily dependent on exports, the deterioration of international competitiveness has devastating effects to the Swedish economy. The unskilled Swedish workers become increasingly dependent on government sponsored welfare and labour market programs. Furthermore, the over-generous Swedish social welfare programs depends on taxation income. High taxation motivates Swedish companies, especially large multinational companies, such Volvo to move to countries with less taxation. All of these factors, and others as well, caused many commentators to question the effectiveness of the Swedish model. The question is whether, with modification in its implementation, it can be sustained or, as some have argued, changing world economic conditions have rendered it obsolete.

## Chapter 7. Which Model for China?

Despite many obvious differences, which might include socio-economic arrangement, the political structure and clearly the stage of industrialisation, both Sweden and Poland saw efficiency as the engine of development, and were determined to achieve efficiency through a process of industrial restructuring.

However, in the vision of the 'shock therapists', Poland put strong emphasis on the market mechanism, and promoted a large-scale privatisation program. It was believed that the firms in the hands of private owners would gain the efficiency necessary for rapid development, because state intervention and in particular state ownership, leads to inefficient allocation of resources. The market, on the other hand, would motivate economic agents to more rational behaviour, and therefore, market institutions " ... [would] be painfully reconstructed." (Sachs, 1993:197; Shirley and Nellis, 1991). Therefore, short-term losses such as increases in unemployment and production losses were expected, and it was believed to be the price to pay for long-term prosperity. As was expected, the shock treatment significantly changed the Polish economic landscape. Six years after the implementation of shock therapy, the former command economic system ceased to exist. However, the price of this economic translation was heavy: millions of Poles



became unemployed and production declined sharply. The heavy losses came also with the spectacular growth of the rate of inflation. The pain experienced was far worse and longer than what had been expected.

The Swedish, on the other hand, assigned the government a significant role in promoting efficiency and a fair system of distribution. The results of the Swedish active policies showed gains in industrial production, strengthened competitiveness and created full employment. The inefficient firms or industries were not supported under the Swedish system; bankruptcies of the inefficient ones made available a pool of labour which the expanding firms and industries could draw upon. Meanwhile, the ALMPs, sponsored by the government, ensured the flow of labour and also the quality of the labour supply. All these factors contributed to the rapid growth and full employment of Sweden.

Both the Polish and Swedish models share some controversies. In recent years, Poland has reversed the economic decline and achieved steady economic growth. Unemployment and inflation are also under control. Poland has been revealed to the world as a new dynamic growing economy. Meanwhile, the success of the Swedish model gradually lost its former glory and became increasingly problematic. Starting from the early 1990's,

Sweden began to experience difficulties with both declining production and a significant growth in unemployment.

At the theoretical level, both 'shock therapy' and Swedish corporatism are not lacking in controversies. To Sachs and his associates, "... many of the key steps of economic liberalisation can be introduced very quickly, indeed virtually overnight by a well-prepared government" (Sachs, 1993:199). The exponents on the other hand criticised shock therapy for its pro-market bias which had led to the general denial of state intervention (Rybczynski, 1991). They argued that rapid approaches such as shock treatment could result in inflation and falling output and employment, as well as harmful effects to public and private investment and consumption. Therefore it is necessary to consider the order and sequencing of the reforms (Rybczynski, 1991; Fry and Nuti, 1992; Rosati, 1993:217).

China has unique characteristics, and the well being of a large part of the population (estimated close to 70%) depends on the employment provided by SOEs. Large-scale bankruptcies of loss-making SOEs can render disastrous massive unemployment. As a consequence, the decline of consumer demand will further plunge the economy into deeper recession. If the recession is only to be short-term, say one or two years (it was expected but was exceeded in the Polish case), shock treatment could be an option in

exchange for long-term prosperity. However, as in the Polish case, the experiences of “shock therapy” suggest that recovery takes longer than anticipated and in some cases is not automatically assured.

China has historically been concerned with unemployment throughout the forty years of the central planning system<sup>1</sup>. With rural de-collectivisation, a huge amount of surplus labour was released from farming. As it was mentioned in chapter 3 and 4, in the past years, rural migration in China often has been the cause of a large part of urban unemployment. The unemployment resulting in large-scale bankruptcies of SOEs will inevitably worsen the already alarming issue of unemployment.

Furthermore, if we look at the practice of privatising SOEs in Poland, shock treatment is clearly not doing well. Table 7-1 indicates that after four years of large-scale sell-offs or even give-aways of SOEs, the number of SOEs remain high. Many observers were therefore not impressed with the slow pace of privatisation.

**Table 7-1 Number of State Firms Between 1990 and June 1994 (Poland)**

Year	1990	1991	1992	1993	1994
No. of SOEs	8,441	8,228	7,245	5,924	5,218

Source: Janusz Lewandowski, 1995, p. 98.

As discovered by Poznanski (1993:19), the employment level in Poland has not declined as steeply as the level of output while industrial production declined by at least 25 percent in 1990. The rate of state

industrial employment declined by about 5.6 percent. In 1991, with the fall of output in state industry at 12 percent, the rate of decline in employment was 8.5 percent. These data show that state enterprises have continued to retain workers; therefore the unemployed in these figures must be newcomers to the labour market<sup>2</sup>. This means that labour productivity in state industry has in fact declined, and that even under the greater financial stresses imposed upon them, state enterprises have, as in the past, continued to be heavily over staffed.

This means that the transition program in Poland remains far from complete, and has failed to increase efficiency and competitiveness in the state sector. Further measures must be taken in the state sector and will inevitably result in closures of uncompetitive SOEs. These will in turn result in more mass lay-offs, and consequently increase the pressure of unemployment. Whether the reforms should be pushed ahead is very much dependant on whether there is enough growth to absorb the laid off workers. If the growth is not enough to form sufficient labour demand, the question then is how should the government handle the large scale unemployment, and how should labour peace be ensured during the uncertain time needed for the transition.

These inter-related factors are crucial in choosing a means to the end. In the past, many who took part in the debates on reforming socialist economies are frequently asked whether they recommend a fast or slow pace of reform. The question itself might be phrased in the wrong way. Indeed, no one would call oneself an advocate of slowness. Rather it is a choice or decision made with regard to the relation between the costs and benefits.

The radical approach practised in Poland in the past achieved rapid macro-structural changes. However, it also contributed to the lengthy recession, the increase of unemployment, poverty and the gap between rich and poor. The Chinese gradualist approach, on the other hand, has fallen in terms of speed and depth of reform. Yet this approach has maintained a substantial rate of growth (contributed largely by the growth of the private sector as result of economic liberalisation) without incurring significant costs, and popular views towards reform remain strong and favourable.

“Nature does not make jumps,” and many found that transition in Poland simply could not be achieved overnight; there were other related elements which could not possibly be changed in a short period of time. Take the example of privatisation. Some found, first of all, that the ideological legacy of communism caused resistance to the measures of privatisation, and led the reform to seek a form of workers self-management

and other "third way" systemic solutions (Lewandowski, 1990; Rapacki & Linz, 1992; Balcerowicz, 1992, 97). Second, there was also a lack of necessary external conditions to privatise state firms, because there was simply no such capital reserve to transfer state assets to the hands of private (Olechowski, 1990; Kokan, 1990). Moreover, privatisation is just about impossible in countries where there is no existence of financial market institutions (Samonis, 1990). Therefore, the Polish government can also be blamed for its inability to undertake prior reforms that would have made privatisation more successful (Cook and Kirkpatrick, 1994).

Third, there are 'behavioural causes'; for example, despite the tightened monetary and fiscal policies, inefficient SOEs may remain untouched. They may resist the reform either by passing the price increases (as a cost-pushed inflation) onto the consumers, or by limiting output, and maintaining their profit in an "easy" way, such as continuing operation by simply building up large inter-enterprise debts and refusing to pay (Kolodk, 1991; Schaffer, 1992; Samonis & Hunyadi, 1993).

Therefore, according to Janos Kornai, privatisation cannot be accelerated by some artful tricks, or some clever organisational form or bureaucratic aggressiveness. It rather depends on the difference in pace

between the growth of the private sector and the transferring of state assets to private hands (Kornai, 1995:52).

The Swedish model, on the other hand, has its merits. Based on the market condition, the Swedish system incorporated a whole policy package that promised to deal with such problems as efficiency without ignoring others such as unemployment and inflation. Efficiency was taken as the engine for gains in competitiveness. This, in return, ensured the rapid development and expansion of efficient firms and industries. Full employment was built on the basis of economic growth and the demand for labour.

The accelerated structural changes were developed firmly, based on the issue of efficiency. The principle is to discourage inefficiencies through government initiated industrial policies. In addition, the ALMPs were ready to deal with the negative consequences, mainly frictional/structural unemployment. As it was revealed in chapter 6 (table 6-4), the Swedish model is more expensive, and above the average spent in terms of shares of GNP among OECD countries. A huge proportion of the spending was allocated to ALMPs, and made the Swedish labour program significantly more expensive than the other OECD countries, based on a cost per person calculation. But considering the Chinese government is spending a similar

percentage of GNP on subsidies for the operating losses made by SOEs (see Table 4-3 in chapter 4), it would make more economic sense to spend money on labour programs, either active or passive, but preferably active measures, that had proven to be cost efficient, such as employment services.

Nevertheless, the forces of the market are not the only option in economic development; government could assist the market to enhance its performance. In fact, according to many development economists, the state will have to play a more significant role for the late developer than in the more developed countries. The state should not only maintain a macroeconomic balance and supply public goods and services, but they should also undertake direct responsibility both for augmenting the economy's investable resources and for establishing a mechanism to transfer those resources into productive investment. A free market, on the other hand, would tend to generate less investment by leaving significant amounts of resources under-utilised (Brett, 1985; Bienefeld, 1982; Chenery, 1959; Lewis, 1955, 1989; Singer, 1949).

However, it should also be noted that the course of development is not solely set by the wisdom or stupidity / strength or weakness of government. Governments may contribute or influence the course of development.



However, once established, markets have their own dynamics and internal logic.

One should also note that there is often a distance between the theoretical and the practical. Under orthodox Marxism theory, planned production and distribution was believed to be the better system to ensure both production efficiency and distribution equity. Yet, in fact, after a century's endeavours of many communist countries which involved close to a third of the world's population, there has been little success in both efficiency and equity under the bureaucratic planning system.

Based on the above analysis, the conclusions are as follows:

1. The Polish shock therapy might be of benefit to long-term economic prosperity in Poland. However, in the short term, it appears to have caused short-term disruptions such as excessive unemployment and inflation.
2. "Nature does not make jumps". The painful experiences of many former socialist economies has largely discredited the shock treatment approach. It is also politically incompatible in the Chinese context. Considering the size of the Chinese labour force, shock treatment can be devastating in terms of unemployment. The rise of unemployment would inevitably incur resistance to the reforms, and cause potential

political unrest. The Chinese political system remains fairly delicate. Any negative reform consequences might easily evolve into an ideological battle, and betray the original purpose of reform. In the past, Deng Xiaoping used programmatic reform practices, and skillfully avoided political conflict by exercising economic reforms without insulting political leftists<sup>3</sup>. A large amount of unemployment can threaten to revive political confrontation, endangering the legitimacy of reform.

3. The Swedish model has been shown to be more expensive; however, a proper implementation of industrial policies, especially ALMPs with a proven record, can significantly reduce the impact (namely of unemployment and production losses) during the period of economic restructuring.
4. It should be noted that the Swedish model is in fact very restrictive. The government intervention is broad and comprehensive. The extensive management and co-ordination can be expensive, and is the main cause of management inefficiency. In addition, the intervention has to be based on the proper information and monitoring. Yet, government has often been revealed to be disadvantaged as compared to the private sector in responding to the market signals.

5. However, the Swedish approach has its merits in the current Chinese context, when considering that the Chinese government spent a similar percentage of GNP annually on subsidising the operation losses of SOEs. It might make more economic sense to spend money instead on some cost efficient ALMP programs. The investment in ALMPs will be productive and will optimise the economic structure. Meanwhile, a reduced rate of unemployment will ensure a stabilised economic transition.
6. At the current stage of the Chinese situation, the Swedish approach may have its merits in term of alleviating pressures, namely unemployment.
7. In the long-run, a competitive market system with government intervention limited only to areas where it has clear advantages might be the only foreseeable optimum solution to various economic issues.

## Chapter 8: The Conclusion

The development of the market has come quite a long way from the unregulated free market to the more regulated one. Starting from the end of the 1970's and early 1980's, mainstream political economic theory shifted significantly from the left to the right, and created waves of deregulation and privatisation among the major industrialised countries. It was at this historical moment that many socialist countries with a command planning system converted their ways and joined the spectacular move towards market capitalism<sup>1</sup>.

The process has proved to be extremely difficult. From Mrs. Thatcher's Great Britain to President Reagan's United States and the current neo-classical reforms in Canada, the process is sometimes 'chaotic', causing social disruption, an increasing rate of unemployment, poverty and a widening gap between the rich and poor. However, for the transitional economies, such as China and other formal socialist countries, the depth of transformation is much greater, and incurs more significant social disruptions than any of the market capitalist systems that needed to be deregulated.

In the past one and half decades, China experienced various types of measures to decentralise the state control of the economy. The reforms were generally agreed to be successful. As a result of China's transformation, China has enjoyed strong economic growth, averaging at about 10 percent annually throughout the 80's. However, with a closer look, one will find that the extensive growth can be mainly contributed to the spectacular growth of the non-state (private) sector. The state sector, on the other hand, suffered stagnation.

In the past years, many reform measures were introduced, starting with the increases in management power, allowing it to shed excessive employees, the minimising of the SOEs' social obligations, to the introduction of bankruptcy laws to rule out the uncompetitive SOEs. Yet, all of these reform measures achieved little gains. In fact, the losses made by SOEs in the past years have increased significantly. Despite the bankruptcy law, many loss-making SOEs were allowed to continue their production at the cost of state subsidies for the protection of employment.

The question of how to reform the SOEs became the central concern of this thesis. Should the state allow loss-making SOEs, which currently account for more than half the total number of SOEs, to go bankrupt freely? How should the state deal with the unemployment resulting from the

bankruptcies? Should the state be responsible for finding new jobs for the unemployed? Or should the state even commit itself to full employment?

This thesis identified two alternative models. On the one hand, shock treatment representing, the free market approach, insists on privatisation before restructuring. Shock treatment is so far the only model that has been proscribed to the former socialist economies in transition. Poland is an example of one of the first and also represents the most complete application of shock treatment. On the other hand, the corporatist Swedish model assigned the state a significant role in correcting market inefficiencies through a set of industrial policies, and promised to provide the impetus for economic restructuring and increased industrial efficiency without incurring significant social disruptions such as unemployment, inflation and stability, etc.

The thesis found that the practice of shock treatment in Poland had dismantled once and for all the former command central planning system in a relatively short time period. However, Poland also experienced the 'pains' of transition, which many agreed to be more than had been anticipated. The exercise of shock treatment resulted in an immediate decline of industrial production, and it was also combined with the sudden increase in unemployment. Consequently, the original public consensus towards the

transition programs was shattered. In recent years, both unemployment and inflation remain the most significant problems. Yet Poland reversed the economic decline and became one of the most dynamic economies in the Eastern Europe block in terms of GDP growth. Many also expect that there will be many years of fast economic growth ahead.

The Swedish approach of economic restructuring, on the other hand, situated itself between the free market and command economy approach. Based on the unique formation of a centralised labour union, the employers' union and an interventionist Social Democratic government, the Swedish government exerted extensive measures (such as employment funds, and the solidaristic wage policy which effect eased union wage pressure) to discourage inefficient firms and industries, and promote efficient ones. Meanwhile, the active labour market policies (ALMPs) were implemented to assist the structurally unemployed in being transferred to the expanding sector. These measures resulted in a broad and comprehensive regulated market system. For nearly three decades, Sweden's Model was an admirable economic model, and many agreed that the Swedish approach had contributed to Sweden's lasting and strong economic growth. The national economy was strengthened, unemployment was limited to 2-3 percent. Yet, in recent years (since the early 1990's), the once widely applauded Swedish

model began to experience some difficulties, including rising rates of unemployment and growing demands on social programs. The expensive social security system contributed to the fiscal catastrophe. The Swedish labour program became increasingly criticised. Many recent studies reveal various problems associated with Swedish labour programs (Blanchflower, David G., Jackman, Richard, Saint-Paul, Gilles, 1995; Lindback, Assar, 1986; 1994). The decline of the Swedish system was also a consequence of changes in international markets and foreign competition coming from less highly taxed competitors.

Based on the unique characteristics of China, it is argued in this thesis that the shock therapy approach is risky, and may not yield any positive results for the following reasons. First, it is likely to create at least a short-term unacceptable level of unemployment, especially when considering the size of China's labour force and the amount of unemployment already existing. Second, as it was experienced in many countries, shock treatments proved to be costly in terms of short-term production losses. In the case of Poland, the promised economic recovery was slower and more difficult than had been expected (the economic recovery was to have taken one or two years; however, it was not until 1995 before the signs of recovery had become evident). Third, the Polish experience provides no evidence that shock



treatment is effective in dealing with the problems of SOEs. The privatisation process was generally slow, the results were disappointing and bankruptcies were still extremely limited. Fourth, the rise of unemployment as a result of the application of 'shock treatment' might incur resistance to the reforms, and cause potential political unrest. The Chinese political system remains fairly delicate. Any negative reform consequences might easily evolve into an ideological battle, and betray the purpose of reform. In the past, Deng Xiaoping used his programmatic reform approach, and skilfully avoided potential political conflict without insulting the political leftists<sup>2</sup>. A large amount of unemployment can be dangerous, reviving political debates on the legitimacy of the reform.

On the other hand, in the short-term, there are many things that China can learn and gain from the corporatists' Swedish model. It serves not only the interest of efficiency, but also provides remedies for the negative consequences. However, the active measures required by the corporatist model are more costly than the passive measures in pure economic terms. Nevertheless, it remains a far better choice than subsidising directly loss-making SOEs. In addition, even if the market approach is ultimately the only viable path to development, if it won't solve any of the present problems, it

loses its purpose of application, especially when it might also damage the present public support of market transition.

Based on the above argument, this thesis makes the following recommendations for the on-going market reform in China:

1. A firm fiscal and monetary policy should limit the subsidies to the lose-making SOEs. The success of the Swedish model was firmly based on the principle of promoting efficiency and discouraging inefficiency. The investment made to efficient and expanding industries makes more economic sense than investing in protecting employment in those loss-making SOEs.
2. It is important to invest and improve employment service agencies to make job information available to those needing it. As it was developed in Chapter 4, as a result of the inaccurate often misleading statistics and unemployment registration system, the current Chinese employment services offered by the various level of local Labour Bureau systematically narrowed the scope of their services, not to mention the needs for improved quality of services.
3. In addition to a proper national social security system, some ALMPs such as training, retraining and also the job creation programs might be necessary to alleviate social disruptions. Even though, these

programs were often proved to be more expensive, however, they were also generally agreed to be effective measures in combating short term unemployment.

4. The government and the government controlled banking system should encourage growing firms or industries, whether they are privately or publicly owned. Jobs created in growing sectors ensure the long term employment prospects. After all the sufficient growth creates demands for labour.
5. However, at the proper time (socially and politically), the government should withdraw and limit its role in the economic arena to ensure a competitive economy, where decisions are made by individual business.

## NOTES:

### Chapter 2:

1. "Internal promotion" implies that instead of recruiting workers from outside of a particular unit, the employer looks to present employees as his source of supply, and workers look to this "internal market" for their prospects of advancement.
2. According to Sharp (1988:31 &41), "... unemployment in democracy ... requires that public opinion be well informed. For democracy to flourish, it is not enough that there be a consensus among experts about the best technical approach to a social question like unemployment; there must also be a broad understanding within society at large about what is at stake in the debate over unemployment. When experts cannot even agree on the fundamental causes of unemployment ... it requires that the views of the public be sought and heeded. It entails a process in which the agenda for decision-making is as democratic as possible." (Sharp, Voyer and Cameron, 1988 p. 31 & 41)
3. Keynes argued that income depends on the volume of employment. The relationship between income and consumption is defined by the propensity to consume; that is, "a given level of income in terms of wage-units, and the expenditure on consumption out of the level of income." (Keynes, 1936 p. 90)
4. According to Keynes, the propensity to consume would increase with the increase of the aggregate real income. (Keynes, 1936:27).
5. According to Rehn and Meidner, high profit of the firm leads to both price and wage push inflation.
6. The active policies were defined as "... policies that are designed to influence the functioning of the labour market", and they might include measures to enhance job information, and counselling and placement services. They also can be distinguished as "supply oriented policies" such as job training and retraining, financial assistance for geographical mobility, etc., and "demand oriented policies", such as programs aimed to create jobs, wage subsidies and other forms of employment subsidies (Van den Berg & J. Smucker, 1992:12).

## Chapter 3

1. See Christopher Howe, 1978 for detailed explanation of the operation of the "People's Commune." P. 66-83.
2. According to China Statistical Yearbook 1990 (pp. 81-97), during the period 1952-78, net agricultural output grew at only 1.8 percent per year. Whereas the population grew at 2 percent per year over the same period.
3. Zhao, Ziyang was later appointed the State Premier and General Secretary of the Chinese Communist Party.
4. Wan, Li was later appointed Chairman of Chinese National People's Congress.
5. For a good description of the HPRS reform see Gordon White, "Riding the Tiger". Stanford University Press, Stanford, California, 1993:100-117.
6. The concept was first introduced by Kornai, in his work "Contradictions and Dilemmas: Studies on the Socialist Economy and Society," 1986. The author defined "hard budget constraint" as the firms spending only as much money as they have. The firm must cover its expenses with income from sales of products. Under the hard budget constraint, a firm is entitled to take bank credit, but the bank is prepared to grant credit only under its regular conditions, with the expectation of profits from interests. The survival of the firm is therefore determined by its financial constraints. On the contrary, many SOEs of the socialist countries are subject to "soft budget constraint," which means that the firm is not entitled to any budget constraints, or the budget constraint is ineffective. The firm may spend more than their actual income, and it does not have to fulfil its obligations for bank credit. Moreover, the survival of the firm is not determined by its financial situation; the state may help out firms by providing various forms of subsidies, or individual exemption from the payment of taxes or other charges. Of course, there are many other means of assistance, such as allowance on the centrally fixed price of an input; open increase of the centrally granted on soft conditions; prolongation of due credit repayment, etc. Since the creation of rural enterprises, firms are faced with hard budget constraint. This ensures competition and makes survival of the firms depend on their profitability. As a result, the TVEs are more competitive than many of the SOEs.

7. Another 30 million are reportedly employed by individual and small private businesses. By comparison, employment in the urban state-owned (including the government) and collective units are estimated to be about the same.
8. Defined in Statistical Yearbook of China as: "... all kinds of people working and getting salaries or wages from their enterprises, institutions, organisations and the subsidiaries of various economic forms, including state-ownership, collective ownership, state-collective ownership, state-individual ownership, China-foreign joint ventures, as well as enterprises or institutions run by overseas Chinese businessmen from Hong Kong and Macao and foreign businessmen."
9. Martin Lockett, in his "Small Business and Socialism in Urban China", thoroughly reviewed the invention and evolution of "the big collectives" (Development and Change. Vol. 17, No. 1, January 1986, p. 35-67).
10. "Fixed workers", defined in Statistical Yearbook of China as "Permanent Staff and Workers", refer to the personnel formally assigned, arranged and recruited under approval as permanent wage-earners by government labour departments or organisation departments. Included are those attendant, absent by reasons, inside the establishment of staff, outside the establishment of staff, working abroad or on probation and those who temporarily work in other units yet are still paid by the original work units.
11. Korzec, M., in his "Labour and the Failure of Reform in China," provided detailed description of this "job inheritance system".
12. For these examples, see Zhuang Qidong on Shangdong Model et.al., "A Long-term Employment Policy is Needed" Guangming Daily (Glorious Daily), 16 August 1985.
13. For these examples, see Zhuang Qidong on Shangdong Model et. Al., "A Long-term Employment Policy is Needed" Guangming Daily (Glorious Daily), 16 August 1985.
14. Also known as "Occupational Inheritance". The hereditary employment system was used in different time phases. First introduced by the former President of the People's Republic of China, Liu Shao Qi, in his reform experiment in Hebei province of China in the early 1960's. The system allows transfer of the right of occupation from father to son upon the retirement of the father. It could also be transferred from mother to daughter, mother to son, father to daughter, husband to wife. It was also a system to accelerate labour turnover through encouraging senior workers to choose retirement voluntarily

and leave vacancies to their direct relatives. The system was later officially cancelled in October 1986, with the introduction of the labour contract system. Moreover, hereditary employment system was part of command labour allocation system that allowed employees of SOEs to choose retirement voluntarily and leave vacancy to their children.

15. Japanese firms tend to encourage employee loyalty through different means. It includes systems that allow steep wage hierarchy according to the employee's seniority within firm. Meanwhile, life employment are offered to approximately 20 percent of its labour force to allure employees' loyalty.
16. Jiang's concept of "labour flexibility" is in relative term to the old China's labour system where all employment were fixed, and there were virtually no labour flow between firms.
17. These items were clearly described in "Regulations on Transforming the Operating Mechanism of State-Owned Enterprises," issued by the State Council Economic and Trade Office on July 23, 1992, which set up the detailed regulations giving effect to the broad provisions of the Enterprise Law (Gao Shangquan1, 1992.) Please see Appendix Text Box.
18. Zhao Shouyi, "Consolidate the Labour Organisation of Enterprises in the Spirit of Reform," Gongren Ribao (Worker's Daily), 30 January 1983.
19. "Notice of the Ministry of Labour and Personnel on Actively Experimenting with the Labour Contract System," February 22 1983. Reprinted in Zhonghau Renmin Gongheguo Guowuyuan Gongbao (Decreed of People's Republic of China) 1983: No. 213; "Temporary Regulation of the Ministry of Labour and Personnel on Recruitment, Testing and Selection of Workers" Bulletin of the State Council of the People's Republic of China, 1983, No. 6, 4 April, pp. 213-17.
20. See Huang Shilin, "Several Problems to be Solved in the Implementation of the Labour Contract System." Economic Management (Jingji Guanli), No. 7 (5 July, 1983), pp. 17-20.
21. "Interim Regulations on the Implementation of Labour Contracts in State-owned Enterprises", 12th July, 1986; "Interim Regulations on the Recruitment of Workers by State-owned Enterprises", 12 July, 1986; "Interim Regulations on Dismissal by State-owned Enterprises of Employees in Violation of Discipline". 12th July, 1986; "Interim Regulation on Unemployment Insurance for Employees of State-

- owned Enterprises”, 12 July, 1986. The above regulation were reprinted in People’s Daily (Renmin Ribao), 1986c:2.
22. As opposed to the ‘shock therapy treatment’ taken by many East European countries, China was often taken as an example of a gradualist approach to economic transition from command to market economy. They share the same goal of reform, however, the gradualist approach emphasises the speed and sequence of reform.
  23. Macartney, Jane, 1996. China Parliament Deputies Enter Bankruptcy Debate, Reuters, 03-11-1996.
  24. Eckert, Paul, 1996. China’s Li Says State Firms Reform to be Cautious, Reuters, 02-05-1996.
  25. “Report of the Work of Government”, delivered by Premier Li Peng to 5th Session of 7th National People’s Congress on March 20, 1992.

#### Chapter 4

1. 1952’s data cited from Statistical Yearbook of China, 1993:119, Table 4-23. At the time, the rate was not identified as that of unemployment, rather as ‘persons waiting to be employed’ and ‘rate of persons waiting to be employed’. By definition, ‘persons waiting to be employed’ refers to those able-bodied urban residents aged 16 to 50 for male and 45 for female, who are looking for employment, and registered at the local bureaux. The ‘rate of persons waiting to be employed’ is calculated as the number of persons waiting to be employed expressed as a percentage of the number of persons employed plus the number of persons waiting to be employed.” (Statistical Yearbook of China 1993:140).
2. This had been the direct result of a baby-boom period in the early 1960’s, and the central allocation system found themselves having difficulty keeping pace with the growth of job demand. In addition, starting from 1978, tens of thousands of youth who had been send down to the country during the Great Cultural Revolution period began to return to the cities, and in fact reinforced the growing trend of job demand.
3. China defines the productive population as those aged 16 years and over, but in this text we follow the standard international practice and use 15 years old as the starting point.
4. The average standard wage means that the workers average wage in the last two years of employment.



5. At the Third Session of the Eighth National People's Congress, which began March 5th 1995, Premier Li recognised that unemployment and inflation are the top concerns for the ongoing market-drive economic reforms (Economist, 1995a).
6. Zhong Guo Tong Ji Nian Jian 1993 (China Statistical Yearbook 1993) p. 140.
7. Graharn Bannock. R. E. Baxter and Evan Davis, 1992. *Dictionary of Economics*, the Penguin, p. 432.
8. Statistics Canada, The Labour Force, December 1995. Catalogue 71-001 p. d-3, d-4.
9. According to Michel Korzec, the regulations on unemployment insurance distinguished four types of open unemployment, namely, workers of bankrupt enterprises; workers whose enterprise was on the verge of bankruptcy and, therefore, was reorganising production and cutting down on its labour force; labour contract workers whose enterprise had ceased to exist or whose labour contract had been terminated; and workers who had been fired. However, it did not cover workers contracted from the countryside and other types of temporary workers.
10. This estimate of redundant rural labour constitute almost 25% of China's total rural labour force.
11. It is hard to estimate the actual number of influx rural labourers. Sometimes the estimation given by the same Ministry of Labour contradicts itself. In another journal report, for example, the Ministry of Labour estimated that there would be 50 to 60 million influx rural labourers in 1995 (Beijing Review, 1994).
12. World Bank, 1992 *A World Bank Country Study, China: Reform and the Role of the Plan in the 1990s*, p. 90.

## Chapter 5

1. The functioning of the credit system under communism is reviewed in great detail by Johnson, Kroll, and Horton (1993).
2. Private ownership has always constituted the central merit of the capitalist system. The belief that the private economic agents motivated by the profits in a free market of competition will lead to the perfection of production dates back to centuries ago. Indeed, privatisation is also a world-wide phenomenon that is not only attached to socialist transitional economy. After the collapse of Keynesian

consensus, it is not hard to see that from Mrs. Thatcher's Britain to Reagan's United States, and today's Liberals in Canada, there has been a tremendous move toward privatisation.

3. As Henry Milner pointed out, attention to inflation in 1951 was extremely far-sighted. Because, despite concern about inflation which is very common today, in 1951, economic strategists on all sides had usually ignored the problem of inflation (Milner, 1989:104).

## Chapter 6

1. Blanchflower found that there is little evidence to link Swedish historical low level of unemployment with ALMPs as of training and job creation. These policies, according to Blanchflower, might have contributed to the long spells of open unemployment and easing cyclical fluctuations in unemployment. However, there were other causes of Swedish low level of unemployment, such as the expansion of public sector, increases of program participants, and it, consequently, created a 'cosmetic effect' of low unemployment.
2. According to Henry Ohlsson's study, he found that, whenever unemployment had increased, new funds have quickly been granted by the Swedish government. There has been a stable and close connection between grants and the number of people in programs: as soon as the funds have been granted, people have been quickly channelled into programs. The volume of the programs decreased as the need declined. Therefore, the job creation programs proved in the past that it is capable in decreasing unemployment level in a systematic way.
3. It should be noted that in recent years the Swedish expenditure on labour market policies increased significantly since 1992, which is inline with the growth in open unemployment.

## Chapter 7

1. Under a socialist planning system, labour was often under-utilised. Consequently, many formal socialist countries had a tight labour market. In the case of the former USSR, in order to accelerate labour turnover, the basic education system was strictly limited to 10 years (five years elementary education, three years junior high and two years senior high school education), so that the youth could enter the labour force earlier. China, on the other, hand had never experienced a tight

labour market. In fact, over the past years China had always had problems providing employment to its huge national population. In the early years of reform, the 10 years basic educational system was criticised, and later the American's 12 year basic education system (six years elementary, three years junior high and another three years senior high school education) was embraced. The rationale behind this was to slow down the rate of labour force turnover by keeping youth at school longer.

2. Hidden unemployment in state industry was estimated at 0.9 million in 1991. This means that if the excess labour were eliminated, the rate of unemployment would be almost double the current rate.
3. In the early reform era, Deng Xiaoping averted political debate on the nature of Chinese economic reform (socialism versus capitalism) by encouraging more attention to 'socialist economic development'. Later on, Deng again bravely extended his 'black and white cats' theory, and argued "... black cat or white cat, whichever catches the rat is the good cat." This was largely interpreted as Deng's determination to achieve economic development without considering or debating whether the means to reach the purpose would be of a socialist or capitalist nature.

## Chapter 8

1. It should be noted that China still claims to be a socialist country. Market capitalism here is referred to as the model system based on the workings of market forces, with minimal state intervention. The state's role is mainly to enforce law and order and contractual obligations, to maintain property rights, to carry out minimal regulatory activities and macroeconomics control, and to produce, or purchase, minimal public goods. This model shares the most common features of the advanced capitalist countries in the West. Theoretically, it is the one proscribed by the neoclassical economists.
2. In early reform era, Deng Xiaoping averted political debate on the nature of Chinese economic reform (socialism versus capitalism) by encouraging more attention on 'socialist economic development'.

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