



Title	Why did Russia and China Go Separate Ways to Transition? : A Comparative Study on Initial Condition and Transition Strategy in Soviet Union and China
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Citation	經濟學研究, 64(2), 45-62
Issue Date	2014-12-09
Doc URL	<a href="http://hdl.handle.net/2115/57552">http://hdl.handle.net/2115/57552</a>
Type	bulletin (article)
File Information	ES64(2)_45.pdf



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# Why did Russia and China Go Separate Ways to Transition? A Comparative Study on Initial Condition and Transition Strategy in Soviet Union and China

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## 1. Introduction

In this article, we are trying to find out the reason why did Russia and China ultimately go separate ways in transition process, as well as why did China's incremental reform could not be successfully duplicated in the Soviet Union by a historical review on the planned system and the market-oriented reform in each country during 1980's. In order to give a convictive interpretation to this issue, this article pays more attention to the relationship between the initial conditions and the transition strategy. Based on a comparative study on the different characters of planned system in the Soviet Union and China, we may find the specific transition strategy with its performance was endogenous to the concrete initial conditions since the space for transition was originally confined by the latter.

In general, there were two paths of reasoning in interpreting the different performance in the transition process, which was the hottest topic in transition economics: Initial conditions and Transition modes debate. Many economists realized the remarkable difference in economic performance among transition countries in 1990s. Some people believed that, because of the gradual reform on the economic system and the strategy of unbalanced promotion in transition, China had found his way to the rapid economic growth with less transition cost through the incremental reform (Lin, Cai and Li, 1993; Fan, 1993). Comparing the remarkable growth of China's economy after her reform and opening with the serious recession in the Eastern Europe and the CIS countries which happened in 1990s, many people seriously blamed to the Washington Consensus" and the "Shock Therapy" under the prevalence of neo-liberalism (Nuti, 1997; Poznanski, 1997; Stiglitz, 1998; Kolodko, 2000). It was regarded as a typical way of radical transition that led to the terrible recession in these countries. Nevertheless, some people argued that the initial conditions were the determinant factor to the specific transition mode with the corresponding economic performance in tran-

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\*This paper was written while being as a joint Ph.D. student in Graduate School of Economic and Business Administration of Hokkaido University. Thanks to Professor Nishibe Makoto and Mr. Yoshihiro Masuda, their sincere guidance and suggestion was significant to the revisions of this paper. This paper was also supported by the State Scholarship Fund of 2013 China Scholarship Council (CSC, No. 201306170126).

sition process (Sachs and Woo, 1994).

Table 1 : The GDP Growth Rate in the Main Transition Economies in 1990s(%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Belarus	n/a	-1.2	-9.6	-7.6	-11.7	-10.4	2.8	11.4	8.4	3.4
Bulgaria	-9.1	-8.4	-7.3	-1.5	1.8	2.9	-9.0	-1.6	4.9	2.0
<b>China</b>	<b>4.1</b>	<b>3.8</b>	<b>9.2</b>	<b>14.2</b>	<b>14.0</b>	<b>13.1</b>	<b>10.9</b>	<b>10.0</b>	<b>9.3</b>	<b>7.8</b>
Czech R.	n/a	-11.6	-0.5	0.1	2.9	6.2	4.5	-0.9	-0.2	1.7
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	0.2	3.1	4.1	3.2
Kazakhstan	n/a	-11.0	-5.3	-9.2	-12.6	-8.2	0.5	1.7	-1.9	2.7
Poland	n/a	-7.0	2.5	3.7	5.3	7.0	6.2	7.1	5.0	4.5
Romania	-5.6	-12.9	-8.8	1.5	4.0	7.2	4.0	-6.1	-4.8	-1.2
Russia	-3.0	-5.0	-14.5	-8.7	-12.6	-4.1	-3.6	1.4	-5.3	6.4
Slovakia	-2.7	-14.6	-6.7	-3.7	6.2	5.8	6.9	4.4	4.4	0.0
Ukraine	-6.3	-8.4	-9.7	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2

\*The Source of the Statistics: World Bank Open Data, <http://data.worldbank.org/indicator>.

The early debate on the initial conditions and transition mode mostly based on the growth in different transition economies we have given above (Table 1). In consideration of the evident difference in economic performance between China and other transition countries during 1990s, the academics was inclined to acknowledge the significance of transition mode to the economic performance, especially based on the rapid growth under the gradual reform in China. The specific transition mode did have an influence on economic performance. However, it could not reveal the reason why a specific transition mode was selected by a certain country in one's transition process, and why a specific transition mode was effective in one country but was ineffective in another. On this occasion, we have to find out the fundamental factor which is behind the economic statistics. Only in this way can we better understand the reality of transition process.

## 2. Economic Transition: Definitions, Doubts and Biases

In order to avoid the misunderstanding of this article, some definition of terminologies must be clarified before we proceed to the main argument. In this passage, we mainly focus on the economic system in traditional socialist countries before their transition, which is the planned system. The "system" is a set of institutions or an institutional matrix, which was formed by the interaction among various institutions. More specifically, the economic system usually refers to the organization of the whole national economy. It displays the relations among the state, sectors and enterprises, the rules of controlling and administrating the whole economy, as well as the operation of the socioeconomic activities. According to the definition of institution by North (2008), the system was also a collection of the formal rules, the informal restrains and the implemental characters, which is similar to the conception of institutional environment. Therefore, the process of institutional change is the reestablishment or reconstruction of the relation among different institutions

within the system. The dynamic change on institutional relation between the “equilibrium” and the “disequilibrium” is regarded as a transition process of the whole system.

However, it must be emphasized that unlike the institutional change in general, the economic transition in this article is more specific and concrete, which mainly deals with the institutional change from the planned economy to the market economy. Despite we make a limitation on this study, it does not indicate that the institutional change in other fields, especially in politics should be ignored. Actually, the relation between the economic transition and political reform is a basic issue of transition economics research. Some economists argued that the political or constitutional change was the essence of economic transition (Kornai, 2000; Sachs, Woo and Yang, 2000)<sup>1)</sup>.

Before proceeding into the main topic of this article, it is necessary to make a response to the common doubts and biases related to the economic transition. The argument which the “gradualism” was better than the “radicalism” mostly based on the fact that China had achieved a rapid growth since her reform and opening, however, the CIS and the Eastern Europe countries were suffering from the serious recession at the beginning of their transition. It should be emphasized that the assessment of economic performance on a short – term perspective was static and one – sided since it does not pay attention to the remarkable growth of the CIS and the Eastern Europe Countries after getting rid of the “transition recession” in most time of 2000s (2000 – 2007). Compared with these countries, though China still maintained a higher growth, its sustainability is now facing a series of challenges resulted from her gradual reform (serious corruption, sustained rural – urban disparity, huge gap of income distribution, severe crisis on environment and ecology, etc.). On the other hand, despite the CIS had experienced an obvious growth before the financial crisis in 2008, and many Eastern Europe Countries (e.g. Poland, Hungary, the Czech Republic and the Baltic States) had successfully attracted a huge amount of FDI as well as achieving early acceptance into the EU at the same time<sup>2)</sup>, they are now suffering from the stagnation in the Post Crisis Era. The latest “Transition Report” published by EBRD (2013) indicated that the prospect of sustained growth in these countries were not promising. Therefore, the assessment of economic performance to all transition countries from a long – term perspective is still unclear. And the “better economic performance” in long time span must be open to debate.

Furthermore, using “gradualism” and “radicalism” to generalize the transition mode was questionable. In a narrow sense, it basically described the strategies and policies that transition countries had implemented, which was an external character of transition mode. The transition mode actually has an extensive meaning, which included not only the speed, but also the scope, the depth,

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1) In view of the long-term effect of the institutional change and constitutional transition, some economist argued that the “dual-track system” played a negative role in economic reform and constitutional transition. Sachs, Woo and Yang believed that the dual track approach to economic transition may generate very high long-term cost of constitutional transition that might well outweigh its short-term benefit of buying out the vested interests (Sachs, Woo and Yang, 2000).

2) According to the statistics from World Bank Open Data, the FDI accounts for the proportion of GDP in the CEB Countries (Poland, Hungary, Czech Republic, Slovakia and Slovenia) and Baltic States was in an average of 6.68% per year during 2001 to 2007. World Bank Open Data, <http://data.worldbank.org/indicator>.

the orientation, and the controllability of an economic transition<sup>3)</sup>. Therefore, being as the internal characters, the driving force, the genetic mechanism, and the expected goal of economic transition could more comprehensively and profoundly generalize the transition process. In addition, considering the diversity and periodicity of specific strategies or policies in transition process, it was inappropriate to use the word “radicalism” to summarize the transition of all CIS and Eastern Europe Countries. In fact, Poland promoted her market – oriented transition in a more gradual way after 1992. Belarus was a typical “gradualism” case since the Lukasenko’s domination. It can be observed that the boundary of “gradualism” and “radicalism” was obscure in many transition practices. On this occasion, these two words was a couple of relative conceptions to the transition economics. In order to better illustrate the topic, in this article, we mainly focus on the transition strategy instead of the transition mode, which will be helpful for us to understand this study more intuitively.

Therefore, according to the arguments we discussed above, there are basically two issues to be further interpreted in the following sections. The first one is if the planned system with its different characters is the initial condition of transition countries, how does it affect (determine) the performance of later reform and transition? The second one is whether the same transition strategy is effective in different country with diverse initial condition?

### 3. Initial Conditions: Planned System with Different Characters in Socialist Countries

To all of the transition countries, the initial conditions are the “constraints” to their later economic transition. We can make a classification according to their relation with the whole economy. Some initial conditions are endogenous to the economy itself, for example, the economic system (planned system) with its duration, the distorted degree on economic structure, the evolution of labor division in economy, the level of social productivity and developing standard. The other initial conditions are exogenesis, which include population, resource endowment and geopolitics, etc. In this section, we mainly discuss the initial conditions which are endogenous to the planned economy by comparing the different characters of planned system in Soviet Union and China. The analysis may lead us to better understand why these two countries ultimately went different ways in the transition process.

#### 3.1 The Ideal Model and the Real Situation of Planned System

Being as an ideal model of planned system, the “Lange Model” was originally introduced in the famous debate on the socialist economic calculation during 1920s – 1930s. In order to response the argument which pointed out by Mises (2008) that the planned system of Soviet – style could not run smoothly without gathering enough information comparing with the market economy, as well as the very high information cost would not lead the planning to properly operate. By using a neo –

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3) Zapf (1998) argued that the character of a social transformation comprehensively included the range, the depth, the speed, the orientation and the controllability. Undoubtedly, the economic transition is also a social transformation process in respect of the institutional change.

classical equilibrium model, Lange (1935) and Taylor (1945) proved that the market socialism could solve the huge computational cost of planning and achieve a higher level of resource allocation than the market economy<sup>4</sup>. Standing on Mises's side, Hayek (1975; 1989) believed that the planning officials had no incentive to perfectly implement the planning, thus they could not regulate the price in order to make the market cleared. Although the "Lange Model" had won the reputation for socialist economics, the exploration to Market Socialism in some Eastern Europe Countries, especially in Hungary, eventually proved that the ideal model of planned system failed in practice (Kornai, 1986).

The real situation or real operational mechanism of planned system in traditional socialist countries was more complicated than what we have preconceived. Despite we can easily find some similarities of planned system in these countries (e.g. public ownership, the government leading in economic administration and operation, and development strategies, etc), they still had evident difference in concrete characters. For example, more market factors and liberalization could be observed in Yugoslavia, Hungary and some Eastern Europe countries in respect of economic administration and operation (Brus and Laski, 1989). The state-owned enterprises in these countries were provided with more autonomy in production and distribution, as well as the pricing mechanism in micro economy was more flexible (Wang, 1989). The exploration to market socialism made the planned system of these countries was more and more different from the Soviet-style one. Unlike the Eastern Europe Countries, in fact, neither the Soviet Union nor China put the market socialism, which being as an ideal model of planned system into practice. However, if we believe that there is no difference in planned system of these two countries, the conclusion might not be prudent. We will generalize the main characters and its consequences of planned system of Soviet-style in the following paragraph. Some of the characters China may be close to the former, though some of them China did not possess.

### 3.2 The Characters and its Consequences of Planned System of Soviet-style

(1) The promotion of socialist industrialization was based on simulating the industrial model of developed capitalist countries, which indicated that the traditional planned system was endogenous to the "catch-up" development strategy. That was the so-called "giving priority to the development of heavy industry" in many socialist countries. However, the development of heavy industry actually did not coordinate with the conditions of resource endowment and the evolution of labor division at that time, the only way to promote the development of heavy industry was to create a price scissors between the agricultural products and industrial products artificially. By maintaining a lower price of agricultural products to the industrial ones, the cost of developing heavy industry

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4) By assuming that the consumer goods market and labor market were established, there would be a "dual-price system" in the planned economy. On this occasion, the price of consumer goods and labor was decided by the market, but the price of capital goods was fixed by the central authorities by means of simulating market competition. Lange believed that, with the simulation of market mechanism and the method of "trial and error", the planned economy could ultimately find the balanced price instead of the market (Lange, 1935).

was greatly reduced, which provided a favorable condition to the accumulation of industrial capital. On this occasion, a set of macro economic policies for maintaining the overall distortion in the price of the products and capital goods was eventually formed. Furthermore, to ensure the flowing direction of these lower-price resources, as well as the surplus accumulation of the economy could make better use for heavy industry, the planned system which including the centralized administration and planned distribution to these resources, with the deprivation of autonomy in micro management would be consequently established (Lin, Cai and Li, 1994). This economic system could maintain the relatively higher profit of state-owned industrial sector by implementing the central-planning to all economic organizations, which implied that the central-planning was used for protecting the interest of state-owned sector by a series of discriminated policies. What is more, the unbalanced development would lead the social resources to over-centralize in specific sector (heavy industry) which was expanding at a much faster speed. It ultimately resulted in the increasing disequilibrium in economic structure (e.g. the serious shortage in the consumer goods but an over-developed military-heavy industrial complex) and low efficiency.

(2) The evolution of labor division in socialist countries was largely promoted by the planned system. In Soviet Union, the authorities organized a large number of state investment programs in order to establish many industrial enterprises which had more specialties by means of central-planning during 1920s-1930s. Based on the simulation of industrial model in developed capitalist countries, the Soviet Union established a specialized network of labor division in the short term by these remarkable state investments (Yang and Li, 2001). Therefore, it is the central-planning that made the labor division become highly-evolved since most of the high quality resources were transferred into the capital-intensive industry, which enhanced the asset specificity of those state-owned enterprises. However, instead of the spontaneous evolution of the market mechanism, which mainly included a fair competition environment with the voluntary transactions of property rights, the network of a relatively specialized labor division was promoted by a consciously designed system (planned system). This leaping evolution of labor division was not good for the economy in the long term. As under the circumstance of denying any other possible way to introduce the alternative mechanisms<sup>5)</sup>, only by intensifying the implement of central-planning could coordinate with the highly-evolved labor division so as to maintain the efficiency of the economy. However, it was almost impossible to achieve since the central-planning itself would fall in malfunction because of its inherent deficiency which was proved by the real situation in Soviet Union's economy since the mid 1970s.

(3) A bureaucracy system with highly-centralized hierarchical structure was established to ensure the enforcement of central-planning from top to bottom. On this occasion, the government and the party (CPSU) had the monopoly to decide the production, as well as to distribute the goods and materials among various sectors and organizations (e.g. the state-owned enterprises and col-

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5) In fact, the Soviet Union's attitude towards the market socialism was seriously negative, especially in Brezhnev's era. After the "Prague Spring" in 1968, the market socialism was completely resisted by the Soviet Union's authorities.

lective farms), and the officials became the agents of the authorities who administrated and supervised the implement of planning. The authorities believed that they had established a very effective mechanism to control and manage the whole economy, since the officials had residual claim right to the operation of planned system. They would have incentives to make the system run smoothly in order to share the maximum surplus. However, the authorities did not realize that without assuming the property responsibility, the manager of the state – owned enterprise had no initiatives to maximize the profit. Moreover, the officials had motivation to maintain the over demand during the implement of the planning since it could increase their power and bring them a lot of intangible benefits. In many cases, the shortage was used for extracting the monopoly rent by the officials. In this way, the monopoly profit which created by the planned system could be covered (Shleifer and Vishny, 1992). With the planned system became more and more bureaucratic, the central – planning was no longer efficient. Being as an informal mechanism of the economy, the serious corruption and nepotism reached the peak during the Brezhnev era in Soviet Union<sup>6)</sup>, which ultimately sowed the seed of her collapse.

### 3.3 Planned System in China: Different Characters from the Soviet – style

Unlike the Soviet Union, the planned system in China had its specific characters. Compared with the highly – centralized bureaucracy system which ensured the enforcement of central – planning in Soviet Union, an effective central – planned system no longer existed after 1958, especially in the period of the “Great Leap Forward”(1958 – 1961) and the “Culture Revolution”(1966 – 1976). As early as 1956, Mao had proposed the administrative decentralization in his famous article “On the Ten Major Relationships”<sup>7)</sup>. By considering the experience of the Soviet Union in her economic construction, Mao proposed the administrative decentralization by encouraging the development of self – sufficient economy in every enterprise and rural production team instead of developing the large – scaled state – owned enterprises by implementing the central – planning (Yang and Li, 2001). As the ownership of these enterprises was divided to all levels of government by administrative decentralization at that time, the self – sufficient economy with backward infrastructure resulted in a low – evolved labor division with a large number of medium or small – sized enterprises. Although China had preliminarily set up her framework of industrialization during 1950s – 1960s, the network of labor division which once was established in the “First Five – year Plan” with the help of the Soviet Union had been evolved much more slowly after China turning to her own way to develop the socialism. According to a related research, China’s rural area was still in a considerable

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6) According to a related research, In Brezhnev era, especially in the late stage of his governance, the corruption in government, party and military completely ran out of control. The officials used their power to increase privilege not only politically, but also economically. Including their families, there were more than 3 million people in the group of vested interest, which accounted for about 1.5% of the whole population of the Soviet Union at that time. More seriously, they were not satisfied with enjoying the privilege. Many of them misappropriated the state property by various means, even used the enterprises and collective farms as their personal assets to engage in semi legal or illegal business, which brought them a huge amount of profit (Lu and Jiang, 1999).

7) However, the article was opened to the public in “People’s Daily” until Mao’s death (Mao, 1976).



degree of self-sufficiency until 1978 (Yang, Wang and Wills, 1992). On this occasion, the administrative decentralization was not good for implementing the central-planning, as well as for promoting a specialized network of labor division

Moreover, in consideration of the administration in state-owned enterprises more easily tended to be bureaucratic, Mao argued that the enterprises should be managed and supervised by people who had good political background instead of the officials who were specialized in management and technique (Qin, 2003). On this occasion, without the central-planning and effective management according to the material balance, the micro production usually did not follow the input-output rules of Leontief as the planned system commonly did. The economic relations among the planning center, the local government, and various production organizations were basically interrupted since the central-planning could not properly operate, which resulted in the overall disorder and chaos of macro economy. As the central-planning actually fell into malfunction, the "Five-year Plans" only had symbolic meaning rather than the practical. It could be found that the plan-making with radical and unrealistic goals mainly cater to the politics instead of considering the real economic situations<sup>8)</sup>. In the late stage of Mao's governance, the implement of central-planning was completely suspended by the political movement during the "Culture Revolution"(1966-1976). The governmental paralysis made the authorities almost lose control of the whole economy when the movement reached at the peak.

What we have discussed above indicates that the characters of planned system in Soviet Union and China have evident difference. Compared with the former, China had achieved a lower degree of central-planning without a systematical administration and operation in economy before 1978. It determined these two countries would have different space for the later transition. We are going to make a further study on this issue in the next paragraph.

### 3.4 A Comprehensive Comparison on Initial Conditions between the Soviet Union and China

Being as an important initial condition, the different characters of planned systems determined the space for market-oriented transition in traditional socialist countries. The degree of central-planning in economy resulted in the remarkable difference in each transition process. Thus, we are going to make a comprehensive comparison on initial conditions between the Soviet Union and China in order to interpret the significance of initial conditions to transition.

Some economist realized the evident difference in development level and economic structure among different transition countries. They argued that being as a backward agricultural society with the farmer as the main labor force, by transferring the labor force from the agriculture with the lower productivity to the industry with the higher one, China gained profit much more easily

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8) A typical example was the "Second Five-year Plan". In order to quickly finished the socialist construction during the Second Five-year Plan and to provide the basis for transiting to communism. The political bureau of CPC discussed and approved "the Resolution on the Second Five-year Plan" on August 1958. According to the indicators of the planning, the total value of farm output would be grown over 2.7 times than that of 1957 in the coming five years. The total grain output would reach 750 million ton, as well as the steel and coal would be reach 80 million and 900 million ton in 1962.

than the Soviet Union. The later, as well as most of the Eastern Europe Countries, which had a higher degree of industrialization and urbanization were facing more difficulties in getting profit during the transition (Sachs and Woo, 1994). The transition indicated the economic structure which was seriously distorted by the traditional planned system needed to be substantially adjusted. However, the structural adjustment mainly contained two components. One is the adjustment on industrial structure, which implies the labor force transferring from the lower efficiency sector (e.g. agriculture) to the higher one (e.g. industry). The other one is the adjustment on property structure by stimulating the development of non – state economy. It should be emphasized that the degree of difficulty in these two kinds of structural adjustment was basically determined by the different planned system, despite the different level of social productivity and developing stage in transition countries also had an influence on economic structure to a certain extent. Nevertheless, the different degree of central – planning with the labor division network had a critical influence on the performance of structural adjustment, as well as on their later transition. To make the argument more convictive, we will interpret it by comparing the concrete initial condition of the Soviet Union and China in the following paragraph.

The interaction between the giving priority to the development of heavy industry and the planned system indicated that the more degree of central – planning in economy, the more distorted industrial structure with the deficiency of incentive, low technical efficiency and unbalanced development would be. On this occasion, the market – oriented transition required the heavy industry which was over – developed under the planned system to solve the problems on redundant personnel, excess capital and serious waste in order to enhance its competitiveness. The adjustment on industrial structure by reducing the proportion of over – developed heavy industry was the common issue to all of the transition countries. However, the difficulty in adjusting was not the same. Compared with China, the heavy industry was more developed in Soviet Union and accounted for a larger proportion (more than 60%) of the whole economy (Xu, 1996). Considering the higher capital intensity and asset specificity of heavy industry, the adjustment would result in more sunk cost during the transition. If still maintained the existing industrial structure, the economy would have no choice but to continually assume the loss, since the over – developed heavy industry had less competitiveness and vitality compared with the emerging industries (Xie, 2002). Therefore, suffered from the higher degree of central – planning which resulted in a more distorted economy, the Soviet Union would have more difficulties in adjusting the industrial structure than China.

In addition, as we have discussed above, the implementing of central – planning was the main reason of the establishment of a highly – specialized labor division network, which had resulted in the capital, the labor force and other social resources more centralized in the state – owned industrial sector. Compared with only 18% of the labor force in the non – agricultural within the China's state – owned sector before 1978, more than 85% of the labor force was working in state – owned industrial enterprise at the same period in Soviet Union (Sachs and Woo, 1999). However, because of the labor force highly centralized in the state – owned sector, as well as the sector was being protected by the subsidy and other discriminated polices, the Soviet Union had very confined space for

further developing the non-state-owned sector during the transition by transferring the labor force to the emerging industry which was export-oriented and labor-intensive as China did in 1980s. Compared with the emerging industries which was more market-oriented in capitalizing the labor force, workers in traditional state-owned industrial sector were used to being provided with the "iron rice bowl" (an occupation with absolutely guaranteed job security, as well as steady income and more social welfare) by the planned system. They tended to struggle to maintain their vested interest (social status and living standard) rather than support the reform or transition. It was common to see that being as a declining industry or sector with less competitiveness, the state-owned industrial sector was more eager to be protected by the planned system. This situation was more obvious in Soviet Union since its state-owned sector had nearly covered the whole economy. On this occasion, the Soviet Union would suffer from a more powerful resistance to the adjustment of the property structure than other transition countries.

It also should be realized that the different degree of difficulties in promoting the market-oriented transition in various areas. As the degree of central-planning and the evolution of labor division in urban was much higher than in rural, it was more easily to promote the market-oriented reform in the latter. Take China's rural area as an example, the lower degree of central-planning and a lower labor division network had provided the development of the small-scale commodity transaction, the quasi private economy and other market factors with a more favorable condition. That resulted in the market-oriented reform firstly began in China's rural area in the early stage of her reform and opening. The establishment of the "Household Contract Responsibility System" in the early 1980s was a reform on the land property right, which provided the farmers with a certain extent of autonomy in production and management. Under this circumstance, the small-scaled household production and individual economy in China began to emerge and develop, which eventually became an increasing momentum to disintegrate the planned economy in rural. Moreover, the emerging township enterprise in China which mainly originated from the collective enterprise and quasi private enterprise during 1970s was getting more and more developing space under the informal system of "ambiguous property right". As transferring the large amount of surplus rural labor force from agriculture with lower return into the processing industry with a higher one, the booming intensification of township enterprise in 1980s had re-promoted the evolution of labor division in China's rural area, as well as enhancing the efficiency of the whole rural economy. Its rapid development was a critical dynamic of China's economic growth, especially in the early stage of her transition. However, with higher degree of central-planning and more specialized labor division network, it was much more difficult to promote the market-oriented reform in urban. Overall, the decentralization and self-sufficiency was more obvious in China than in Soviet Union, which implied that the market factors could developed more easily on the edge of planned system in China.

The comparison we have discussed above indicated that the Soviet Union and China respectively confronted the different initial conditions which resulted from their remarkable difference in planned system. Compared with the Soviet Union, China had a more extensive space for her later reform and transition. It also provided China with more space and flexibility to select the concrete transition strategies. In next section, we will analyze the relationship between initial condition and

transition strategy so as to prove that the specific transition strategy was not selected by chance but was endogenous to the initial conditions.

#### **4. Transition Strategy: A Historical Review on Different Performance of Market – oriented Reform in Soviet Union and China**

In this section, we are going to find out the reason why China and Russia ultimately went separated ways in transition with different strategies. Based on the different performance of reform in the early stage of transition under different initial conditions between the Soviet Union and China, we will find the answer why the specific transition strategy was effective to one country but was ineffective in another.

##### **4.1 “Gradualism” or “Radicalism”: Incremental Reform and Stock Reform**

We usually define the gradual transition (gradualism) as implementing the incremental reform in the whole economy at first in order to provide a better condition for the overall transition. It emphasizes the stability and controllability of transition by promoting the market – oriented reform step by step so as to reduce the transition cost as much as possible. The incremental reform, which being as a reform strategy, was to promote the market – oriented reform on the edge of planned system by choosing a Pareto – improved way rather than adjusting the vested interest directly so as to achieve a smooth transition (Yang, 1994). Its logic behind the transition was by gradually introducing the market mechanism into the economy, the individuals who participated in the business activities would have more chances to gain profit so as to improve their situation. However, in order to provide the compensation mainly by a covert transfer payment to people who had lost his benefit during the market – oriented transition, the function of planned system still be maintained in the specific field by various way. On this occasion, based on balancing the interest of different groups in transition process, the transition cost would be reduced as much as possible (Lau, Qian and Roland, 2008). However, the radical transition (radicalism) argues that to promote a large scale market – oriented reform by implementing the liberalization and privatization more rapidly and completely. To avoid being stuck in the intermediate forms of transition process, it more directly promotes the stock reform rather than the incremental one by implementing a substantial adjustment on socioeconomic structure. On this occasion, the stock reform often implies an essential change on the existing system by redistributing the interest and reconstructing a new framework of rules.

Compared with China, many people believed that Russia directly implemented a radical reform on the stock part at the beginning of her transition. However, they seldom realized that the Soviet Union also had promoted a gradual reform on planned system before her collapse. Why did Russia ultimately abandon the gradual way and choose the radical one? Was it an arbitrary selection in transition process? In fact, this was not always the case. To a large extent, it determined by the initial conditions, as well as the real economic situation of Russia at that moment. In consideration of the Soviet Union’s failure in promoting market – oriented transition gradually by incremental re-

form, Russia ultimately chose another way to the market. We are going to further interpret this argument in the following paragraph by respectively reviewing the different performance on the market-oriented reform in the early stage of transition in Soviet Union and China.

#### 4.2 The Different Performance on the “Dual-track System” and the Incremental Reform

Being as an intermediate form of China’s gradual transition, a “dual-track system” was established in 1980s by improving the material incentive in order to achieve a higher efficiency of resource allocation. It divided the existing system into two parts: the internal (the stock part) and the external (the incremental part). As the external one was operated by the market with more material incentives, it grew much faster than the internal which was still controlled by the plan. The strategy of “dual-track system” was to make the resources from the low-productive sector transfer into the higher one without damaging the capacity of the internal. When the external became powerful enough, the “demonstration effect” would function, which could further drive the internal to be reformed (Fan, 1993). On this occasion, the establishment of “dual-track system” was a typical case of incremental reform. During the early stage of China’s market-oriented transition, the whole economy benefited from “dual-track system” since it recovered the order by maintaining the plan and enhanced the efficiency by introducing the market (Jin and Qin, 2012), all of which could hardly find in economy before the reform and opening. During the period of “dual-track system” (1984–1992), China achieved an average annual GDP growth rate of 9.82%<sup>9)</sup>, as well as the evident increase of emerging industry (e.g. process industry and service industry) and private economy. Therefore, the reform had provided China with good condition for the further transition.

The Soviet Union had also established a kind of “dual-track system”, which the state-owned sector and the non-state-owned one were coexisting in the economy during her gradual reform (1985–1989). However, the failure in promoting the economic growth eventually aborted the reform. By reviewing the “dual-price system” (A “dual-track system” on price fixing) between the Soviet Union and China, Zhang (1997) realized the tiny difference between these two country in gradually promoting the incremental reform. He argued that unlike the “dual-price system” with strict quota restriction in China, the “dual-price system” without basic quota restriction in Soviet Union had resulted in a huge amount of resources flowing into the private sector excessively. On this occasion, there was an increasing shortage and decline in production in the state-owned sector, as well as the whole economy. During 1986–1990, the Soviet Union suffered from a weak growth with only 1.8% of average annual aggregate social product (Lu, 2007). As the decline in the state-owned sector was much faster than the growth in the non-state-owned one, the growth of the “external” could not provide enough compensation to the whole economy within the “dual-track system” as the case of China, which made the incremental reform in the Soviet Union completely meaningless.

Compared with China, there were three important reasons of Soviet Union’s failure in promoting

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9) The Source of the Statistics: World Bank Open Data, <http://data.worldbank.org/indicator>.

the gradual transition with the incremental reform. (1) Firstly, the state – owned industrial sector accounted for a larger amount of proportion in the whole economy of Soviet Union, which had centralized the vast majority of the social labor force (over 90%)<sup>10</sup>. It left only a little space for the development of non – state sector by means of the incremental reform. In consideration of the rapid growth of incremental profit in non – state – owned sector of China mostly relied on absorbing the abundant of surplus rural labor force from agriculture, however, it was almost unrealistic in Soviet Union for the non – state – owned sector to absorb the labor force from agriculture or state – owned industrial sector. What is more, the state – owned sector with the higher capital intensity and more complementation among various inputs was harmful to the free flow of capital goods to other sectors. Thus, the development of non – state – owned sector in Soviet Union by implementing the incremental reform was limited to a large extent.

(2) Secondly, the higher degree of central – planning and administrative control in economy was more likely to lead the related sector to be protected by more subsidy and higher welfare, which was not a favorable condition to promote the incremental reform. Being a victim of the strategy by giving priority to heavy industry, the peasant in these two countries both had suffered from the unbalanced development for a long time. Compared with the social security network in China only covered about 20% of the whole population who was working in the urban state – owned sector during 1960s – 1970s (Yang and Li, 2001), a security wage system guaranteed by the national bank was established in Soviet Union in 1966 to improve the living standard of the rural, which indicated that the peasant in Soviet Union had almost shared the same level of social welfare (basic wages, medical care, pension insurance and other social securities) as the worker in urban state – owned enterprises (Jin and Qin, 2012). As the peasant in China was less protected by the planned system, on this occasion, by bringing more profit to the peasant, especially enhancing their living standard, the incremental reform in China was actually a Pareto improvement to the rural economy since peasant could gain more benefit without damaging the vested interest of other's<sup>11</sup>. However, the effect of the incremental reform in Soviet Union was not so remarkable, since the peasant from the state – owned or collective farm was used to living under the protection of existing system. It was more difficult to provide enough incentives to release this part of labor force out of the state – owned sector. From their point of view, the reform or the later transition was full of risk and uncertainty because of the profit was no longer guaranteed.

Moreover, the incremental reform with market – oriented character also implied the decentralization from top to bottom would bring more vitality to the local, which was good for the incremental part of the economy having more chances to gain profit. The prevalence of administrative decentralization in 1960s provided a basis for the regional decentralization by institutionalizing the

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10) In 1985, there was 93% of the social labor force working in state – owned enterprises, 6% of it was working in collective farm and consumer cooperation (co – op), only 1% of the social labor force working in individual or private enterprise (Xie, 2002).

11) The peasant gained more profit from increasing the grain purchase price by the Chinese government in 1980s. However, a subsidy was also provided to people who live and work in urban area as a kind of compensation to the higher food price.

financial relationship between the central and the local in China's later reform. As the collection of the revenue and the profit from the state-owned enterprise was clarified by a set of rules (e.g. to separate the tax authorities, as well as the tax items between the central and the local) among all levels of government during the transition, a financial federalism with Chinese characteristics had been gradually established, which greatly promoted the rapid growth of the local economy (Moneinola, Gabriella, Qian, and Weingast, 1995; Qian and Weingast, 1997). On the contrary, the higher degree of central-planning and bureaucracy system implied that there was less decentralization in Soviet Union's economy. Because of the local state-owned enterprises and local revenue was uniformly managed by the central, the autonomy and incentive of local development had been restrained for a long time, which resulted in a sustained stagnation of Soviet Union's economy since the mid 1970s. It should be realized that a better macro economic environment was the prerequisite for promoting the decentralized reform. However, the Soviet Union began to substantially solve this problem under the overall deterioration of financial condition in the late 1980s. Since the government actually lost the control of the decentralization, the reform quickly developed into a battle which the local fought for wealth and privilege with various motivations.

(3) In order to better accomplish the production quota under the planned system without the capacity of state-owned sector being damaged in the process of the incremental reform, a powerful centralized government was needed to ensure that the market-oriented transition was being promoted in a smoother and more gradual way (Murphy, Shleifer and Vishny, 1992). By reviewing the successful experience of China's rapid growth, Popov (2011) argued that a powerful state system and an efficient administration with a strong mobilization mechanism were beneficial to China's early reform. However, since the Gorbachev's political reform had seriously weakened the authority of the CPSU and the government, the authorities ultimately had no enough power to control the orientation, as well as the development of the whole economic reform. On this occasion, the Soviet Union turned to the radical way (e.g. "500 Days Program") as soon as the "dual-track system" with the incremental reform completely fell into dilemma.

### 4.3 From "Gradualism" to "Radicalism": A Rethink on Soviet Union's Reform and Russia's Choice on Transition

Compared with the China's experience in 1980s, there was no denying that the economic reform in Gorbachev's era completely failed, which resulted in a more serious crisis not only economically, but also politically to the Soviet Union. The failure in reform eventually did not save the country, but became a last straw that broke the camelback. Why did the market-oriented reform with the same strategy have different consequence between the Soviet Union and China? The reason in short, was the Soviet Union did not have enough favorable conditions for implementing a gradual transition with the incremental reform. It was the initial conditions that determined the success or failure to a specific reform and transition to a large extent. Being influenced by a much higher degree of central-planning with an economic structure of seriously distorted, the "stock part" (state-owned sector with more protection by the planned system) in Soviet Union's economy was so powerful that there was only confined space for developing the non-state-owned sector and the



market factors by gradually promoting the incremental reform. The higher degree of central – planning and the highly – specialized network of labor division in economy eventually resulted in more difficulties to the transition from the plan to the market, especially in a gradual way. However, the situation in China was obviously different from the Soviet Union, which determined China could experience a gradual change in economy by firstly promoting the incremental reform at the beginning of her market – oriented transition.

Being as the main successor to the Soviet Union, The failure in promoting the market – oriented transition gradually by implementing the incremental reform, as well as her eventual collapse had profoundly impacted Russia. Moreover, with over 80% of the heavy industry centralizing in the new country after the collapse of the Soviet Union, Russia was another giant military – heavy industrial complex with a large amount of state – owned sector in economy at the beginning of transition (Xu, 1996; Hu, 2004). On this occasion, the serious distortion in economic structure, the long – term effect of central – planning, and various unsolved problems which accumulated in the former reform by Soviet Union were totally left to Russia. In many ways, being as the initial conditions, these issues had become a heavy burden to Russia’s later transition.

There are many conclusions to be used for interpreting the reason why Russia finally went to the radicalism. Many people believed that the political motivation of Yeltsin and the radical reformist, the economic interest of Russia’s oligarch and the international monopoly capital, the influence of the neo – liberalism thought, the social mood of anti – communism and anti – Soviet Union, as well as other conspiracy theories<sup>12)</sup> could interpret this issue (Kolodko, 2000; Glazyev, 2003). These arguments were not wrong, however, they might ignore the fundamental reason behind the phenomenon to a certain extent. Without considering the reason that had resulted in the Soviet Union’s failure in her gradual reform, we could not provide a convictive interpretation on why did Russia turn to the “radicalism”. In essence, as the highly – evolved labor division network had been operated by the planned system in Soviet Union for a long time, to terminate the central – planning also indicated the function of the labor division network would fall in malfunction. On this occasion, considering the gradual reform was more easily to result in the whole economy relying on the central – planning continually, a radical way with implementing the stock reform more directly was needed in order to thoroughly separate the economy from still being controlled by the old system (Yang and Li, 2001).

In consideration of the Soviet Union’s failure, based on almost the same initial conditions, Russia realized to gradually promote the market – oriented transition by the incremental reform was also inadvisable to the new country. Since the existing reform was unworkable that had already been convincingly proved by the experience of Soviet Union, Russia would not choose the same way as the former, despite the radical transition implies much more cost in the short – term and it indeed was not the optimal strategy. On this occasion, it was not surprised to see the change on transition

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12) As Glazyev (2003) pointed out in his book, the “shock therapy” in Russia had resulted in the serious reduction of population quality as well as leading the country to be colonized. The radical transition was a policy of genocide on behalf of the Russia’s oligarch and international monopoly capital.



from the “gradualism” to the “radicalism”.

## 5. A Brief Commentary on this Study

In order to find the reason why Russia and China ultimately went separate ways to market – oriented transition, this article mainly studies on the initial condition of the Soviet Union and China. We argued that the initial condition was significant to the transition by a comparative research on the different characters of planned system in these two countries. To prove that a specific transition strategy was endogenous to the initial condition, we also make a historical review on the different performance of the market – oriented reform in Soviet Union and China. It should be emphasized that, to better answer the questions we have left in the article, as well as better understand the diversity of transition process between Russia and China, we have to pay more attention to “what they had done” rather than “what they will do”. The different transition from the plan to the market with its different strategy was originally determined by the initial condition, especially by the different character of planned system in these two countries. The latter had a critical influence on the performance of the market – oriented reform and further determined the different way to transition. According to the different transition in Russia and China, it should be emphasized that the “optimal transition strategy” was a relative conception since the specific strategy was restrained by the initial condition. On this occasion, the “radicalism” in Russia had its “rationality”.

This study is not interested in evaluating the “optimal” transition strategy or policy by assessing the economic performance of different transition countries. Still now, we have not established a perfect model which is generally acknowledged by the academics to comprehensively evaluate the achievement of transition countries. What is more, the “performance” itself does not merely indicate the GDP growth, but with an inclusive criteria on socioeconomic development. On this occasion, many issues of transition economics are still open to be discussed. Instead of interpreting the transition issues according to the statistics, especially arguing “what strategy should transition country adopt”, this study mainly pays attention to the “process” rather than “consequence” of different transition. That is to say, to analyze the reason of the diversity in transition process. Although making sensible strategies and policies is of utmost importance to transition country, by reviewing the historical process to better understand the present situation also should not be ignored. Only in this way can we understand the transition issues from an objective viewpoint.

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