ECONOMIC TRANSITION IN CHINA AND RUSSIA

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Abstract

Two of the most profound economic events of the past few decades were the collapse of communism in the Soviet Union and the rapid emergence of the market economy in China. The paths of economic transitions in the two communist countries have been distinct. China's transition away from state socialism is generally considered a success while Russia's is not. Why did China have a better transition away from a communist economy than Russia? This study compares and contrasts the evolution of the Chinese and Russian economic reforms over the past few decades. It examines many differences and a few points of similarity. Differences include initial conditions and political leadership as well as external economic environments. Nevertheless, despite Russia's ongoing economic difficulties, both countries have made substantial progresses in their moves from communism to capitalism. The two countries are currently converging on a similar economic model of state-led development.

Keywords: Economic Transition, Shock therapy, Gradualism, Market Economy

Introduction

The economic reforms in former Soviet Union and China in the late twentieth century have raised questions as to how each country has handled transitioning away from communism. Russia and China each have a unique history, but both countries established command economies following their respective communist revolutions based on the idea of Karl Marx. Those revolutions established the Communist Party as the dominant force in the political and economic life of both countries. The Russian revolution of 1917 produced a communist dictatorship under Vladimir Lenin and, later, Joseph Stalin and others. The Chinese revolution of 1947 also resulted in a communist dictatorship under Mao Zedong. At the heart of the communist ideology was a state ownership of capital and land. Therefore, Russia had been under a planned economy for nearly eighty years whereas Chinese had experienced a planned economy for about thirty (Marsh, 2005).

The collapse of Soviet communism was rapid and unexpected. In 1991 the Soviet Union broke into several newly independent states, the largest of which is the Russian Federation (Russia). The immediate reason for the collapse was political: a clumsy, failed attempt of old-line communists to take control of the government. However, a number of economic problems, some stemming directly from the failures of central planning, contributed to the collapse of the Soviet Union. In 1991, Russia pursued a rapid and radical transformation to private property and free markets. It is called "Radicalism," or "Shock therapy," and it achieves irreversible reformations. In 1992, Russia concluded that its political apparatus, particularly the Communist Party, was an obstacle to economic reform and political reform (democratization) was needed. In contrast, China's market reforms began far earlier in 1978 in a piecemeal, experimental, and gradual manner called "Gradualism," or "Controlled transition" (Sachs and Woo, 1994). China sought economic reform under the strong direction of its Communist Party. It understood that the upsetting the political system would generate endless debate, competition for power, and ultimate stagnation and failure in economic reforms. Unlike Russia, China feels that communist dictatorship and a market economy can be compatible. China has preserved its state-owned enterprises while simultaneously encouraging the creation of competing private enterprise.

China has increased its economic standing in the global world exponentially since beginning its market reform in the late 1970s. In contrast, Russia's economy has seemingly declined since its transition to a capitalism in the early of 1990s. Therefore, it is widely acknowledged that China has been vastly more successful than Russia in its transition from a planned socialist economy to a market economy. Scholars on this subject mainly focuses on two primary causes of the different outcomes. The first is the policy choice taken by the governments. The other is the initial conditions of the countries. In order to find the determining factor and larger role in the relative success of China and relative failure of Russia, this study compares and contrasts the evolution of the Chinese and Russian economic system and process of economic transition in the countries over the past a few decades.

Initial Conditions

The initial conditions at the beginning of economic transition in China and Russia were very different. The incentives and constraints created by the initial conditions had a direct effect on the outcomes of economic transition in China and Russia. These initial conditions of the countries may be divided into three general categories of difference: economic structure, political condition, and foreign influence.

Economic Structure

At the onset of its transition in the late 1970s China was still underdeveloped and overwhelmingly agricultural. About 70% of Chinese population were peasants. It had a small and uncompetitive industrial base and minimal scientific capacity. China struggled with the problem of excess population relative to the available land, resulting in the availability of cheap labor. China was relatively resource poor. China's GDP per capita was only $150 compared to Russia's $3,427 at the onset of transition in China and Russia (World Bank, 2015).

Table 1: Table1. Economic Structure in China and Russia: Employment by Sector (%)

China			Russia		
Year	**Agriculture**	**Industry & Construction**	**Years**	**Agriculture**	**Industry & Construction**
1978	71.9	15.8	1991	12.9	42.3
1995	53.4	22.7	1994	14.9	37.9

Source: Maddison, *Chinese Economic Performance in the Long Run*, 1998; OECD, *Economic Surveys: The Russian Federation 1995*, 1995.

Unlike China, by the late 1980s the Soviet Union was a military superpower competing with the United States. Russia was a mature industrial economy with an educated labor force and a world leader in science and technology. Only less than 15% of Russian population worked in agriculture. Russia faced a declining population and chronic labor shortage despite its rich natural resources. Russian economy was traditionally controlled by large central ministries while Chinese economy was controlled by regional governments (Sachs and Woo, 1994). This may provide an explanation as to why enterprise managers in Russia accumulated enough power to overshadow the central leadership while the Chinese leadership remained strong. Russian agriculture was heavily centralized and inefficient, characterized by costly giant state farms and tiny peasant plots. Because of the heavily industrialized structure of the Russian economy, labor was overly specialized and difficult to reorganize. On the other hand, China's rural labor force did not face this problem during the economic transition. (Sachs and Woo, 1994).

Table 2. Corruption Index in China and Russia in 1996-2005

Year	Country	Rank	CPI Score (1-10 scale)
1996	China	50	2.43
	Russia	47	2.58
1997	China	41	2.88
	Russia	49	2.27
1998	China	52	3.5
	Russia	76	2.4
1999	China	58	3.4
	Russia	82	2.4
2000	China	63	3.1
	Russia	82	2.1
2005	China	78	3.2
	Russia	126	2.4

Source: Transparency International, *The global coalition against corruption,* 2008.

Corruption was a debilitating factor for both countries, acting as, a drag on efficiency and a turn-off for foreign investors (Rutland, 2008). According to Transparency International's Corruption Perceptions Index, based on surveys of international businessmen, Russia was ranked to 126th out of 159 countries surveyed in 2005, with a score of 2.4 out of 10, while China was seen as less corrupt, ranked 78th with 3.2. The situation is unchanged since 1998, when Russia ranked 76th out of 85 with 2.4 and China 52nd with 3.5. Its practice is so commonplace at both high and low levels that bribery and clientilism seem to be the glue holding the political system together (Sun, 2004). The character of corruption in China shifted after 1992 as marketization took root and the role of connections (*guanxi*) diminished (Sun, 2004). Leaders in both Moscow and Beijing claim that battling corruption has been a top priority, but their actions have barely made a dent in the problem (Rutland, 2008).

Political Condition

Like quite different economic conditions, the political evolution of the two countries prior to 1980 was also very distinct although both Chinese and Russian elites saw the need for reform. Although the Communist Parties of both China and Russia were similarly structured with centralized bureaucratic rule, noted by a large Party apparatus and a close state/party administration, there were important differences in the system. The Chinese Communist Party (CCP) was rebuilding in the wake of the Cultural Revolution (1966-76), which had seriously damaged its organized coherence, governing capacity, and popular legitimacy (Åslund, 1995). This event left much of the administrative capacity of China in shambles (Woo, 1994). Deng Xiaoping, a dedicated reformer, removed his competitors from power right after Mao's death in 1976. Therefore, there was no longer a struggle nor any alternative centers of power in China. This strong leadership was necessary to carry out economic reforms as it helped prevent potential reformation short-circuiting by the party bureaucracy as they seek to advance their own interests. Unlike Russia where power was decentralized in the hands of a few middle ranked party bureaucrats, the middle ranks of the CCP were governed by parallel rule where government officials are supervised by party committees (Shirk, 1993). Moreover, the CCP established "Party groups" that took over the job of administering the government and supervised enterprise managers. This practice helped to prevent the enterprise mangers from hijacking reforms to their advantage. Thus, the CCP avoided the fate of its Russian comrades. The CCP, unlike Russia in the 1990s, never let big businesses take over politics..

The initial political conditions in Russia were relatively not conducive to successful reform. In the Former Soviet Union, power was spread through the top bureaucracy with too little power in the hands of the top leadership to make effective reforms. Much of the economic power rested primarily in the enterprise managers who had enough room to act autonomously (Åslund, 1995). The Soviet Union had experienced 20 years of stability in 1964-1982 under General Secretary Leonid Brezhnev. He delegated much of the political power down to the industrial ministries and regional party secretaries. Thus, much of the real political power rested in the hands of the *nomenklatura*, not in the leadership. This period also produced rising corruption, bureaucratic ossification, economic stagnation, and a number of costly foreign policy adventures, such as the invasion of Afghanistan and a renewed arms race with the US. In the 1985, Gorbachev started reforms very similar to those of Deng Xiaoping. It was a state-led slow transition to the market that starts with letting small businesses operate privately. The paths of China and Russia, however, diverge as Russia accelerates in the early 1990s.

While China avoided the breakdown of economic coordination because of its strong government, the result of the partial reform in Russia was the breakdown of economic coordination (Murphy, Shleifer and Vishny, 1992). Consequently, the Soviet elites were disbanded, forcing economic reform in Russia to be accelerated. The ruling Communist Party of the Soviet Union (CPSU) was divided between pro-Union and anti-Union politicians. The Communist Parties of the Soviet republics had been relatively autonomous by the late 1980s. Their leaders wanted more independence as the economy was still centrally planned by Moscow. This separation led to the August 1991 coup when the heads of three Soviet republics unilaterally removed Gorbachev, the Soviet Union's elected president, from power. Those were the heads of Russia, Ukraine, and Belarus - the same republics that founded the Union. When the Soviet Union collapsed, the new central government did not have much choice in the policy it could pursue. The workable gradual reform could not be applied to the newly formed Russia. The designers of the Russian market reforms aimed at destroying opposition inside the elite. They called it "separating the economy from politics." The opposition groups were called "red executives" who run Soviet plants and farms. They were former Communist Party members seeking to retain centralized control over the economy. They eventually had been removed from decision making. Therefore, the split in the Soviet elites eventually led to rapid economic changes that eventually failed to preserve existing linkages within the Soviet economy.

Ironically, the quality of Russian democracy arguably peaked in 1990-1991, the last year of the Soviet Union. In 1992-1996 politics settled down into an ugly standoff between a reformist president and an opposition-dominated parliament, and after 1996, the level of competition steadily eroded from election to election (Rutland, 2008). According to Freedom House (2005), the most well-known democracy index based on the level of political rights (PR) and civil liberties (CL) using a 1-7 scale, with 1-2 being “free” and 6-7 “not free,” Russia was ranked as “partly free” with a 3 for PR and 4 for CL from 1993 through 1997. However, Russia’s grade slipped to 4/5 in 1999 and 5/5 in 2000-2003. Finally, in 2004 Russia was relegated to the category “not free” with a 6 for PR and 5 for CL. Contrastingly, there has been less variation in the political climate in China, especially since 1989. Freedom House scored China a 7/7 from 1972 through 1977 when it jumped to 6/6. In 1989 it slipped back into 7/7 and stayed there until 1998, when it rose to 6 for civil liberties and 7 for political rights. Freedom House has kept that score for China through today.

Table 3. Political Rights and Civil Liberties in China and Russia in 1975-2000

Year	Political Rights in China	Civil Liberties in China	Status	Political Rights in Russia	Civil Liberties in Russia	Status
1975	7	7	Not Free	7	6	Not Free
1980	6	6	Not Free	6	7	Not Free
1985	6	6	Not Free	7	7	Not Free
1990	7	7	Not Free	5	4	Partly Free
1995	7	7	Not Free	3	4	Partly Free
2000	7	6	Not Free	5	5	Partly Free
2005	7	6	Not Free	6	5	Not Free

Source: Freedom House, *Freedom in the World Country Ratings: 1972-2006,* 2006.

Foreign Influence

China and Russia commonly relied on external integration as a key driver of their economic transition. However, their experiences with foreign countries diverged. Foreign investment in China was important in the success of its development (Kotz, 2001). China had a surplus of labor in the late 1970s, the same time that Hong Kong and Taiwan were experiencing a shortage of low wage workers. Their geographical proximity and shared culture allowed for China to integrate Hong Kong and Taiwanese supply chains, building up their industrial sector. China not only emerged as a leading source of low cost labor in the region, but also opened the way for special economic zones near Taiwan and Hong Kong. These successes helped make China’s reforms successful (Sachs and Woo, 1994). Capital from Japan and the United States to China also developed skills in transportation, electronics, and tourism. Foreign investment was substantially changed from only $7 billion in 1991 to $25.76 billion. China also had a small foreign debt at the time of transition (Nolan, 2004, 184). China’s economic regeneration was led by an explosion of manufacturing assembly plants in coastal locations, importing components and raw materials and exporting manufactured goods to foreign markets, and tapping into its seemingly limitless supply of cheap labor.

On the other hand, the uncertainty that ran throughout the Russian political sphere affected foreign investment and aid at the time of economic transition growing. In contrast to the Western response to the Baltic States, the West did not provide Russia enough aid to ensure that full economic liberalization stood on a firm financial foundation (Åslund 2000). To make matters worse, political collapse also led to a collapse in trade. Because of the 1990s slump and the breakdown of the Council for Mutual Economic Assistance (COMECON) trading bloc, Russia’s share of world trade fell from 3.4% in 1990 to 1.5% in 2000, recovering slightly to 1.8% in 2005. In contrast, China’s trade has tripled in every decade, upgrading its share in world trade from 0.8% in 1978 to 7.7% in 2005. Furthermore, Russia was deeply in debt at the time of transition growing from 10% of GDP in 1990 to 33% of GDP in 1995 to 95% of GDP in 2000 (Rutland, 2008).

Unlike Russia, the Chinese relied on an influx of foreign direct investment (FDI), while keeping portfolio investors at arm’s length. China attracted an annual average of $12 billion FDI 1985-1995, rising to $78 billion in 2006 (Huang, 2003). Russia averaged only $1.3 billion FDI per year 1985-95 and $12.5 billion in 2006, while experiencing an annual outflow of capital far in excess of those figures (Rutland, 2008). China also preserved tight controls on capital flows. The Chinese Yuan (Renminbi) was convertible on a current account, but not on a capital account. It was pegged to the dollar after 1995, at a rate equal to about 25% of purchasing power parity (PPP). Thanks to these controls, China has maintained its cheap labor advantage and has prevented the speculative capital inflows and outflows that have devastated other developing economies. China rode out the 1997 Asian financial crisis largely unscathed (Rutland, 2008, 13). In contrast, Russian reformers largely followed Western advice to pursue external liberalization because IMF credits were conditional on such policies (Stone, 2004). Russia lifted many capital controls in 1992-1994 and dollars flooded in, forming a parallel currency for most of the 1990s (Rutland, 2008).

Table 4. Foreign Direct Investment (net inflows) in China and Russia (million dollars)

Year	**1980**	**1985**	**1990**	**1995**	**2000**
China	57	1,659	3,487	33,787	38,399
Russia	N/A	N/A	N/A	2,065	2,714

Source: The World Bank Group, *Data and Statistics: Quick Query*, 2009.

Thus, at the beginning of economic transition, the initial conditions in China and Russia were very different. China had a more decentralized economic and political structure, a much larger share of agriculture in total employment, and a much lower level of economic development. These reasons simply meant that China had a much higher potential to achieve a faster growth rate after transition, irrespective of its execution. Conversely, initial conditions and especially political collapse in Russia stymied its economic transition. Nevertheless, despite their different starting points and heading in different directions, the two countries are now converging on a similar model of state-led development in the face of common global challenges and opportunities (Rutland, 2008).

Table 5. Reform Paths in China and Russia

	Sequence	***Pace***	***Initiative***	***Spirit***	***Western advice***
Russia	Politics First	Rapid	Top-down	Shock therapy	Strong influence
China	Economy first	Gradual	Middle-up	Controlled transition	No influence

Source: Rutland, P. (2008).

Debates on Policy Choice

There is the contrast in paces of reforms in China and Russia. The conventional wisdom is that China has followed a gradual path since 1978, while Russia has embraced shock therapy in 1992. The Chinese were burned by a century of failed efforts at radical change and were thus philosophically committed to incrementalism (Fewsmith, 2001). In contrast, Moscow had grown tired of decades of incremental change, and the crisis conditions of early 1992 seemed to leave Boris Yeltsin with no option but to embrace radical reform (Gaidar, 1990). Because of the different initial conditions, Russia adopted the neoliberal transition strategy (NLTS: radical economic reform) while China used a state-directed transition strategy (SDTS: gradual economic reform).

Some Western scholars doubted the efficacy of the NLTS from the start. They argue the radical economic reform explains why Russia collapsed economically in the several years following transition. As the evidence of severe transition difficulties in Central and Eastern Europe (CEE) and the Newly Independent States (INS) mounted, the amount of the critics grew. However, the critics have mainly drawn from the margins of mainstream economics. The NLTS is popular with mainstream Western economists because they assume that private property and free markets are the optimal economic institutions, that privatizing property and freeing markets from state control is always desirable, and that this process should happen as quickly as possible (Kotz, 2001).

The critics on the radical economic reform insist that this type of transition strategy has a disastrous effect in the case of Russia in the short term for several reasons: 1) taking apart the old centralized system before an effective market system is ready leads to economic chaos; 2) fast liberalization following a tightly controlled economy results in a vicious cycle of inflation that is hard to contain; 3) tight fiscal and monetary policies to contain this result in depression and prevent the restructuring and modernization of industry; 4) a fully-open trade policy exposes domestic producers to superior foreign competition before they are ready to compete; and 5) in the absence of a legitimate wealthy class, control of state assets is gained by a minority of individuals - with little short term, easily measurable gain for society.

China, on the other hand, kept a dual system of prices under which state enterprises had to provide a certain quality of output at the lower plan price with an output above that level sold at the market price. Central planning was not immediately dismantled, but was retained for the state sector although it relaxed over time. While China welcomed foreign investment, it protected its domestic market considerably. In summary, rather than seeking to directly convert its state-owned, planned economy into a private, market-based one, China used it as a base for launching a new, non-state, market-based sector (Kotz, 2001).

Nevertheless, mainstream scholars in Economics have proved largely impervious to the apparently impressive China/Russia contrast as well as to the arguments of the critics of the NLTS. A good example of the reaction of mainstream economics to the China/Russia contrast was found in the World Bank study, *From Plan to Market*, which seeks to provide a comprehensive analysis of the experience of economic transition (World Bank, 1996). This study provides a window into the reaction of mainstream economists to the uncomfortable China/Russia contrast. Considering the Chinese example, they state the need to privatize is not equally urgent in all settings. Slower privatization is viable. However, the study quickly adds that slower privatization is not necessarily optimal suggesting that if China had immediately privatized, its growth rate would have been even higher than they achieved. Despite its documentation of China's remarkably rapid transition growth, and of the severe depression experienced by Russia and other CEE and NIS countries, this study avoids drawing the most obvious conclusion. It does so by 1) downplaying the severity of Russia's economic collapse; 2) attributing the differential China/Russia records to different initial conditions rather than different transition strategies; and 3) suggesting that China's impressive achievements occurred in spite of, rather than because of, its different strategy (World Bank, 1996).

Conclusion

Market reform began earlier in China than in Russia, and it was based on "Gradualism" rather "Shock therapy." The key elements of China's economic reform were decollectivization of agriculture, establishment of township and village enterprises, price reforms, establishment of privately owned urban enterprises, creation of special economic zones, development of support and control institutions, and corporatization of state-owned enterprises. Since the beginning of market reform, China's real output and per capita income have grown at average annual rates of 9% respectively. Nevertheless, the Chinese economy faces remaining problems of incomplete property rights, under-development of financial institutions, lack of full integration with the world economy, and great unevenness in regional development.

The former Soviet economy collapsed under the pressure of declining economic growth, poor product quality, a lack of consumer goods, a large military burden, and agricultural inefficiency. Russia has committed itself to becoming a capitalistic market economy since 1992. Ingredients in its transition from central planning to markets include: 1) creating private property and property rights, 2) removing domestic price controls, 3) promoting competition, and 3) opening the economy to international trade and finance, and 4) ending inflation. However, Russia's transition to a market economy has been accompanied by declining output and living standards, increasing income inequality, and social costs such as corruption, organized crime, rising alcoholism, and reduced life expectancy.

In the case of Russia, a bad and messy transition meant an almost certain collapse during the 1990s as was also the case for all other NIS and CEE countries, who adopted the same model. However, when looking at the big picture, the Russian economy has finished going through the predicted transition pain. Although Russia still faces difficult economic times, it has made substantial progress in its move from communism to capitalism. It has rebounded strongly and consistently over the last 10 years and is set to continue to do so. It will come close to China over the next 25 years, but current estimates are projecting its GDP to overtake those of UK, France, Germany, Italy, Spain, Canada, and even Japan during that period.

Though the policy choice of China and Russia did contribute to relative success of the economies, this study argues that the initial conditions were the determining factors in the relative success of China and relative failure of Russia. In addition, it is impossible to separate the initial conditions of the countries from the policy choice because the policy choice was the consequence of the initial conditions. Therefore, there are cleaner and more complete explanations for why Russia's and China's economic transitions resulted in such vast differences. Most of that can be summed up by a vastly inferior transition strategy in the case of Russia and China's significantly more favorable initial conditions for growth at time of transition.

China and Russia have taken different paths in their transition to market systems. It may seem that China's path of dictatorship and gradualism is superior economically to Russia's path of swift transformation to capitalism. While Russia has suffered years of declining output and income, China has experienced very high rates of economic growth. However, we must not be too hasty in reaching this conclusion. The disorder arising from Russia's abrupt transition to democracy and capitalism may be in the past, placing Russia in a stronger position than China to succeed in the future. The Communist Party's dictatorship in China may or may not last. History suggests that economic freedom often creates demands for political freedom, free elections, and so on. Is China's period of disorder still to come? Or is a gradual path toward political reform by Chinese Communist leaders working again?

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