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**Bachelor Thesis**

**Comparison of Economic Transformation in China  
and Vietnam**

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## Declaration of Authorship

Hereby I declare that I compiled this thesis independently, using only the listed resources and literature.

Prague, July 20, 2010

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signature

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## Abstract

First part contains general characteristics about authoritative and totalitarian economies, differences between these countries, opinions and knowledge of scientists dealing with this issue and also confrontation of both regimes. Another part is about economic transformation in Asian countries, especially China and Vietnam. Further this thesis brings nearer political system and structure of government and economy of these countries. I discuss here whether the system works and will work in the future or the economies need to be reformed. What is the role of the state in these countries?

Keywords: state, transition, China, Vietnam

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## Abstrakt

První část obsahuje obecné charakteristiky o autoritativních a totalitních ekonomik, rozdíly mezi těmito zeměmi, názory a poznatky vědců zabývajících se touto problematikou, a také konfrontace obou režimů. Další část je věnována ekonomické transformaci v asijských zemích, zejména v Číně a Vietnamu. Dále tato práce nahlíží blíže na politický systém a strukturu vlády a ekonomiky v těchto zemích. Zde budu diskutovat, zdali systém funguje a bude fungovat v budoucnu, nebo je ho třeba reformovat. Jaká je role státu v těchto zemích?

Klíčová slova: state, transition, China, Vietnam

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## 1. INTRODUCTION

When the country Pitch Land did all the reforms needed for applying the market economy, meaning removing the trade barriers, privatizing state enterprises, keeping public debt and inflation on low levels, removing price controls, having flexible labor market and opening the economy to the world market, everyone would expect the country having a rapid economic growth. Instead of that the economy had a very poor growth, foreign investment stagnated and the country went through a deep social problems.

On the other side, the country Lucky Republic had a gradual implementation of the reforms. The process was under experimental way and the changes were applied on the basis of the method trial error. Only some major sectors were selected for the reforms before the implementation on wider basis. Though the country grew at unexpectedly high rates, private and foreign investment increased, and more than 400 million of inhabitants got above the poverty line.

What went wrong in Pitch Land and how did the Lucky Republic manage to undergo such a rapid economic development? *“Economic growth is the most powerful instrument for reducing poverty. Where there has been the least amount of growth, there is also the greatest incidence of poverty.”*(Rodrik 2007) In this time of globalization, the countries have to aim to greater openness to the world market and those which did not oversee their opportunities can fully benefit from the globalized world. Therefore the national policy chosen is very important for the success of the country on the field of economic development.

To answer the question above we can use regression or non-regression models finding which variables are significant for the growth of the country and what policies are needed to change. Except the econometric analysis we need to look at the country as whole from the cultural and historical view. The same policies in both countries do not surely lead the countries to the same economic level. The mentality and preferences of the citizens are different and the response to the policies applied can be various. *“The growth policies are context specific, because of the environments, where firms and households are situated, varies in opportunities and constraints.”*(North 2005) We cannot implement the policies without taking into account the country’s specific contextual, cultural, historical and geographical basis.

Whatever the country is or how different its citizens are, we cannot forget an important role of the government. The theory, that the government should leave a room to the market and its participants to rule the economy, is obsolete. The government plays an essential role in the economy of the country even though its interests are sometimes not sincere and transparent. *“While the government is blamed as a harmful mechanism for private interests, without it the country would be as an uncontrollable car with no driver rushing from one side to another.”*(Kornai and Qian 2009) We have to be critical to our government to protect our democracy, but we have to also understand that controlling a limited budget is not so easy.

In the late 1980s the fall of the iron curtain caused many sets of policy principles to be developed. One of them was the Washington Consensus, which emphasized the importance of the free market. It was a list of the necessary reform steps, compiled by the World Bank and International Monetary Fund on the failure of

post-war "import substitution" and "inward looking" economic and political orientations. What are its shortcomings?

*"The Washington Consensus did not take into account cultural, historical and institutional differences between different countries."*<sup>1</sup>

While the original program declared market infrastructure building as one of the goals, it reduced to privatizing in any way. Experience has shown that the policy of liberalization, stabilization and privatization without supporting institutions may not be successful.

To restore market is not enough to liberate the economy (to cancel the planning, price controls, to restore private property). An essential part of the restoration market is the creation of market institutions and rules, and the aim of the institution is precisely define these rules. The free market assumes a clear and firm order. *"Without the order it will reverse to the tyranny of some powerful players."*(Kornai 1992)

Douglass North, the winner of the Nobel Prize in Economics in 1993, confirms that the economic performance is determined by a mix of formal rules, informal norms and methods for their enforcement.

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<sup>1</sup> Stiglitz, Nobel Laureate in Economics

Pillars of the original Washington consensus adjusted by some market institutions and rules

1 <sup>st</sup>	Fiscal Discipline
2 <sup>nd</sup>	Redirection of priorities in public spending in health, education and infrastructure
3 <sup>rd</sup>	Tax reform, expanding the tax base, reduction of marginal tax rates
4 <sup>th</sup>	Interest rate liberalization, financial liberalization
5 <sup>th</sup>	The single market and interest rate
6 <sup>th</sup>	Trade liberalization
7 <sup>th</sup>	Removing the barriers to foreign direct investment (FDI)
8 <sup>th</sup>	Privatization
9 <sup>th</sup>	Deregulation, particularly to facilitate the entry and exit into the
10 <sup>th</sup>	Securing property rights
11 <sup>th</sup>	Corporate governance
12 <sup>th</sup>	Anticorruption
13 <sup>th</sup>	Flexible labor markets
14 <sup>th</sup>	WTO agreement
15 <sup>th</sup>	Adherence to international financial codes and standards
16 <sup>th</sup>	Prudent capital-account opening
17 <sup>th</sup>	Non-intermediate exchange rate regimes
18 <sup>th</sup>	Independent central banks/inflation targeting
19 <sup>th</sup>	Social safety nets
20 <sup>th</sup>	Targeted poverty reduction

We could say that the list of 20 rules from the Washington Consensus that the country should follow is also the list of key elements of a growth program. Consider

China's boom since late 1970s and Vietnam's boom since late 1980s (Chow 2010). These two countries were undergoing a rapid growth. While both of them headed to the market economy, none of their policy rules matched "the post-Washington twenty". Vietnam's reforms were gradual with a slow restoration of private property. China did not even accept the private property rights regime in late 1990s.

Why the countries such as Pitch Land (we can match this kind of countries to Brazil, Argentina, Mexico, Bolivia, Peru), which adopted the reforms needed for applying the market economy, do not have as high growth rates as China and Vietnam (Lucky Republics) have?

In my thesis I want to focus on economic growth of China and Vietnam. I want to give an answer to the question: why have some countries grown more rapidly than others and how can we construct growth strategies according to this experience. Furthermore we can find out that no growth strategy is perfect and it is not possible to implement the same growth strategy package to every country. We need to unwrap the package and put together the policies that are appropriate to local opportunities and constraints. The successful economy is not only if it can launch economic growth, but it also has to sustain its growth.

## 2. PRESENT CHINA

After the Cultural Revolution whoever came to China would say that this country needs reforms, reforms starting in rural areas where the majority of poor live. The agriculture in China faced low productivity and decreasing production incentives. This should be resolved by immediate price liberalization and land privatization. With the price liberalization there is the increase of food prices which implies the corporatization of State owned enterprises (SOEs) and in order to globalize the trade and bring the price discipline to the country there is the need of the trade liberalization coming along with the reforms in financial sector. And, of course, we have to secure sufficient income during the period of unemployment by applying the social reforms. But while these steps seem to be logical in order to establish property rights and achieve macroeconomic stability, China decided to take a different way.

Price liberalization in agriculture was applied partially, after fulfilling the obligations to the state, farmers were allowed to sell crops in the market. Prices were still determined by authorities and the system of planning maintained. Land privatization was solved by the system of household responsibility and township and village enterprises. This solution ignited the increase in share of household and small enterprises in industrial sector to more than 50 percent in 1990 (Chow 2010). Here China benefitted from sophisticated network of local governments. Kornai and Qian (2009) describes the environment in China as a place where property rights were effectively more secure under the ownership of local government than being in private hands.

China's dual track reforms differs significantly from other reform strategies in Asia as India's gradualism, Taiwan's protectionist trade strategy or open trade policies in Hong Kong and Singapore. If any of the countries tried to apply the similar policies as in China, it failed. Even the Soviet Union came up with a similar idea of household responsibility system and two-track pricing during 1980s but with no success. *"An immediate implication is that growth strategies require considerable local knowledge."*(De Haan 2007)

In the 1970s and 1980s many developing countries were undergoing rapid growth as China and other East Asian countries. But their growth was short term. The vast majority of the growth ended in those countries after few years. In Latin America it collapsed in the early 1980s as well as in sub-Saharan Africa. *"Sustaining growth is more difficult than igniting it, and requires more extensive institutional reform."*(Rodrik and Wacziarg 2005) In the long run, to maintain growth and ensure stability the country has to establish high-quality institutions. This contains the protection of property rights and the rule of law. Those institutions can be described as formal and informal. The relative importance of formal institutions increases with broadening scope of market exchange.

High-quality institutions can take multitude of forms and the probability of convergence is very low. *"Economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement."*(North 1990)

### 3. GROWTH

So what keeps growth low in some countries that took necessary reforms? Is it because of inadequate returns to investment or inadequate access to finance and technology? Is it due to poor property rights, high taxation or labor capital conflicts? When an economy is undergoing recession or weak performance it is usually due to government or market failures. Such distortions prevent the economy from using its resources in the most efficient way. They drive a wedge between private and social valuations of specific economic activities.

Let's define the wedges as  $\tau = \{\tau_1, \tau_2, \dots, \tau_n\}$  with  $\tau_i$  as the distortion in activity  $i$ . Using this definition we can model a constraint on policy decision making problem which is as follows:  $u_i^s(\tau, \dots) - u_i^p(\tau, \dots) - \tau_i = 0$  where  $u_i^s$  and  $u_i^p$  are net marginal valuations of activity  $i$  by society and private agents. We need to know that the private and social valuation functions depend on all the wedges in the system so the distortion in one activity affects the first order condition for other activities.

Let's define  $u$  as welfare of the average person. Then how do the distortions affect every person's welfare? Equation (1) maps the marginal gain in welfare from reducing one of the distortions, and  $\lambda_i \geq 0, i = \{1, 2, \dots, k\}$  are the Lagrange multipliers.

$$\frac{du}{d\tau} = -\lambda_j + \sum_i \lambda_i \frac{\partial [u_i^s(\tau, \dots) - u_i^p(\tau, \dots)]}{\partial \tau_j} \quad (1)$$

The first expression on the right-hand side of the equation (1) shows the direct effect of a small change in  $\tau_j$ .  $\lambda_j$  is therefore a marginal gain in welfare from reducing the distortion in market  $j$ . As the cost of the distortion increases the magnitude of  $\lambda_j$  also

goes up. The second expression shows other distorted activities which is typical of reforming economies. It describes the effect of changing  $\tau_j$  on the weighted sum of the gaps between social and private valuations. When  $\lambda_i = 0$  for all  $i \neq j$  then only the first expression, the direct effect matters. Otherwise we can see that if on balance the effect of all distortions is to reduce gaps between social and private valuations then the decrease in  $\tau_j$  make the welfare grow. On the other hand if on balance the effect is to increase these gaps the welfare gain will be negative along with the decrease in  $\tau_j$ .

Let's assume  $i$  as an intermediate input production and  $f$  as a final good production. The tariffs that are imposed on  $i$  and  $f$  are  $\tau_i$  and  $\tau_f$ . Now consider the reduction in  $\tau_i$  while keeping  $\tau_f$  constant. While the tariff on the intermediate input decreases producing a direct welfare gain captured by its own multiplier, the final good is still protected. This widens the gaps between private and social valuations, because it increases the private profitability. So on balance the effect is to increase these gaps, which means by reducing  $\tau_i$  the welfare gain will be negative.

This was one of macroeconomic illustration that we can consider as one of the key problems of reforming economies. We can solve this problem by eliminating all distortions; the multipliers associated with each if them then go to zero and the increase in welfare can be guaranteed. But it is very difficult to find out all distortions and even more difficult to get rid of them. Two ways that Rodrik (2007) offers are *Target the largest distortions* or *Focus on the most binding constraints*.

The first strategy is concentrating on the largest wedges ( $\tau_j$ ) between private and social valuations. After we order the distortions from the largest to smallest, we start removing them one by one. The difficulty with a *Target the largest distortions* reform strategy is that even if we know all distortions and are able to order them, we will never be sure that the reforms with biggest impacts on economic welfare and growth will be undertaken first. For example, the highest taxes can have very limited impact on growth.

The second strategy seems to be much more practical. The reform priorities here are set according to the magnitude of the direct effects (the size of  $\lambda_j$ ). The idea is to focus on the reforms where the direct effects can be reasonably guessed to be large. As we can see in the equation (1), as long as we are concentrating on removing the distortions with the largest  $\lambda_s$ , the welfare effect will most probably be positive. Rodrik (2007) suggests following this principle: “*Go for the reforms that alleviate the most binding constraints, and hence produce the biggest bang for the reform buck.*” How can we define these binding constraints? How do we locate the distortions with the largest impact on economic growth?

As we know the growth depends on the returns to accumulation, on their private appropriability, and on the cost of financing accumulation. We need to find out the distortions that are connected with the most severe constraint mentioned above. Before we choose the right distortions to remove, let's consider a growth model

$$\frac{\bar{c}_t}{c_t} = \frac{\bar{k}_t}{k_t} = \sigma[r(1-\tau) - \rho] \quad (2)$$

Where  $c$  = consumption,  $k$  = capital,  $\tau$  = tax rate on capital,  $\rho$  = the world rate of interest,  $\sigma$  = elasticity of intertemporal elasticity in consumption, and  $r = r(a, \theta, x) =$

rate of return on capital ( $a$  = indicator of total factor productivity,  $\theta$  = index of externality,  $x$  = availability of complementary factors of production). These variables are all the possible factors that have an impact on growth. Our task is now to select the one with the largest positive direct effect.

The structure of the analysis can be portrayed as a sequence of questions that are in logical order. The very first questions would be as follows. Are the returns on investment inadequate? Is the private appropriability of the returns poor? Or is it a case of inadequate access to finance? If it is due to low returns on investment, is that because of insufficient supply of complementary factors of production, or because of poor access to technology? If the private appropriability of the returns is poor, is it because of high taxation, weak institutions, learning externalities, or labor-capital conflicts? And finally, if there is a great barrier in accessing finance, which financial market is going wrong, the domestic or external ones? Going further this way we can actually narrow the problems down to the most binding constraint on growth.

#### 4. GROWTH STRATEGY

The last quarter century has witnessed an overwhelming improvement in the living conditions of hundreds of millions of people in all parts of the developing countries. According to World Bank, over 400 million of people got over an imaginary one-dollar-a-day line since 1989 to 2009. This could be achieved only due to the intensive economic growth in some of the poorest and most populous countries in the world as China, India, and Vietnam. The number of people earning a dollar a day has fallen in South-East Asia, but has stagnated in Latin America, and even increased in sub-Saharan Africa. Asian countries with their stunning growth rates broke all the rules and conventions that had been thought to be the best for an economy to grow. China and Vietnam liberalized their economies in a gradual, dual-track manner, did not undertake ownership reform, and protected themselves from GATT. China entered WTO in 2001, Vietnam in 2007.

One may ask: Have Latin American countries undertaken enough reforms? Have the results of the reforms up to appear? And finally, isn't it true that Asian countries did well by also following the reforms set by Washington Consensus? The answer to all the questions above would be definitely NO. Latin American countries and even sub-Saharan African countries spent more political capital to pursue Washington Consensus than any other South-East Asian countries and the growth in Latin America and sub-Saharan Africa should follow immediately after right reforms are done. There is no reason for the delay of returns on reforms to be 10 years or more. And finally, it isn't true that China and Vietnam followed Washington Consensus advice. Yes, they did turn to markets and globalized. Yes, they did liberalize. But the ways that they did was not simply liberalize and open up. *"They did so by grafting a market track on top of a plan*

*track, by relying on TVEs (township and village enterprises) rather than private enterprise, and through special economic zones rather than across-the-board trade liberalization.”(Kornai and Qian 2009)*

As we can see on the existence and application of Washington Consensus, the economists are not able to definitely design growth strategies. China and Vietnam have performed very fast growth while having highly protected home markets. They managed to integrate into the world economy by other means (export subsidies, special economic zones...) than the standard policy recommendations. Let's have a look now on the approach that the country should lean to instead of applying this laundry list of policies and recommendations.

Growth diagnostics is the first stage where we need to find out the most binding constraints on economic growth. Sub-Sahara African countries would not be as poor as today if they knew from which side to start the reforms. *“The trick is to find those areas where reform will yield the greatest return.”(Rodrik 2007)* It means that we need to figure out where the most significant constraint is. Otherwise, we are condemned to so called a *spray-gun approach*. Spray-gun approach means that you reform in as many areas as you can, hoping that some will ignite the growth get your country to prosperity.

When the essential issue is found we have to design the appropriate policy to target the market failure and distortions as closely as possible. One would say elementary problem, but because we apply these policies in the developing world, there are more than just one distortion or constraint on growth. If China had repealed the state control system in agriculture and started to privatize land immediately, it would have

not had such a success in growth. Applying these logically-seemed policies would have cut the government off important source of income, leading to higher prices and wages which would have resulted in macroeconomic instability.

In this case, China released the two-track pricing system solution which gave households the right to sell their crop production that was in surplus after delivering the obligatory output to the state at controlled prices.

Township and village enterprises (TVEs) were another successful story of Chinese transformation. In contrast to East European post-communist countries China did not applied the private property system. For spreading private ownership and make it work it is necessary to have an effective judiciary system with high enforcement of property rights. In many countries in Eastern Europe this was overseen and many investors realized that the private ownership was not worth it as should have been. Therefore in the developing countries, where the system of courts is not strong, it is better to start with the co-operational system between entrepreneurs and local authorities. This happened in South-East Asia and helped both China and Vietnam to spur private investment much greater and better than it would have been if they did in European style.

## 5. VIETNAM'S TRANSITION

Vietnam has experienced very similar application of the reforms as China, starting with less complex reforms and continuing with more sophisticated reforms, after positive experience with initial changes and accepting them. The speed and nature of the reforms here is on a daily debate between two groups of moderate and radical agitators. After Ho Chi Minh's death the Vietnamese Communist Party (VCP) separated into two fractions, hardliners and soft-liners.

The conservatives (hardliners) are part of coalition of party ideologues, state-owned enterprise (SOE) managers and members of military group, who are deeply convinced in functionality of a socialist-based market economy. They fear of the negative impact of the market and too rapid change in all major sectors. The reformist (soft-liners) consisting of senior party members and the members calling for change, in contrast, stressed on the efficiency of the system. They wanted Vietnam to open the economy to the world market.

Vietnam's economic transformation "*doi moi*" (=renovation) resulted from the depletion of the economy during the 1970s and early 1980s, when Vietnam was centrally planned economy. In December 1986 at the Sixth Party Congress, the leaders recognized the need of private ownership structure in Vietnam and approved the *doi moi* program.

*Doi moi* program consisted of a radical reform package with the aim to liberalize and open the economy to the world market. The package contained the following items: agricultural reforms, encouragement of the domestic private sector and FDI, removal of

trade barriers, price liberalization, devaluation and unification of the exchange rate, increasing interest rates to positive levels in real terms, and reduction in subsidies to the SOE sector.

However, the main question still remained unclear for the Congress. How the communist party and its fundamental ideology can go along with the reforms? In late 1989, when the collapse of communism started in Eastern Europe, a multi-party system reforms were on a debate. The reformist leader, Tran Xuan Bach, was afterwards removed from the Politburo and several reformers who supported the idea were politically persecuted. The VCP leadership could not accept any possibilities of losing superiority in the country, but on the other hand to gain support of the population they responded by the set of amendments: secret ballot voting, separated functions of party and state institutions, selection of leaders both within and outside the party, the party policy being subject to the law made by the National Assembly. The collapse of communism in Eastern Europe made the party more cautious about any liberal changes to the system and as Chinese leaders the Vietnamese also aimed to the transition model without any significant changes in the political system.

Since 2000, according to World Bank, Vietnam has been ranked in top 20 countries with the highest growth. In 2003 it was 6.00 % increasing to 8.50 % in 2008 and in 2010 slowed down to 5.30 % of growth.

Services and construction were undergoing rapid growth during 1995 to 2005. Almost 2.5 million new private entrepreneurs and household businesses were created in urban areas. The private sector became a major source of employment in the economy.

Concerning SOEs, the government reduced their subsidies and gave them greater autonomy. Inefficient enterprises with serious financial problems have been liquidated and the number of SOEs decreased by 50 percent (Tran Van Tho 2004).

The trade and investments have been liberalized in an attempt to integrate the economy with the rest of the world. Trade agreements have been signed with about 60 countries and there have been trade relations with more than 170 countries. Since 1992 Vietnam agreed on a preferential trade with the European Union (EU). In 1995 it became a member of the Association of South East Asian Nations (ASEAN) and in 1998 Vietnam joined the Asia Pacific Economic Co-operation (APEC). This positive economic integration culminated in the signing of agreements to join the World Trade Organization and the bilateral economic partnership with Japan in 2007.

Liberalization process brought a rapid growth in FDI to the country between 2000 and 2008. Since 2001 Vietnam managed to attract about another 50 countries to invest inside the country. FDI has become a major source of the Vietnamese economy. To serve the trade and investment well the banking sector was reformed. Two-tier system replaced the mono-banking system and the State Bank of Vietnam began to play a new role of the supervisor of the financial system.

In spite of the speed and width of liberalization, it was recognized that some important restrictions remained in the areas of market entry or financial sectors. The reforms have not kept pace with economic development and the question of sustainable growth was on a debate. Political pluralism was rejected, but many fundamental issues

were questioned such as trade and market entry, public administration, economic pluralism. The various fractions of the VCP made a compromise on the following steps of the reforms: political stability, openness and the need of reforming at Vietnam's own pace.

In the end the application of reforms was slow. Gradualism was the result of compromise between various fractions of the VCP. The gradualism was again stressed on several plenum meetings between 1997 and 2007. After the Asian crisis the main ideas of reforms were stability, unity.

After the Ninth Party Congress in 1996, Nong Duc Manh replaced Le Kha Phieu on the position of General Secretary and was again re-elected in 2006. This reform-minded leader pushed the demand stimulus policy through to revitalize the economy. This stimulus package included budget injection to poverty reduction programs, raising wages and salaries, encouraging people to consume, financial subsidies for SOEs, and supporting firms to expand exports.

Both conservatives and reformers recognized the need of stability of a political system and both are worried about the changes that can lead to the collapse of the regime. Therefore, the concept of political liberalization had been lost before it could have been adopted.

## 6. MARKET AND SOCIALIST PRINCIPLES

Marxism-Leninism has always been interpreted in various ways; the socialist reforms in China and Vietnam are launched by the government and party leaders who contribute their views and visions on reforms. In this spirit, all ongoing debates are being held. The fundamental boundary to reform is the ideology, the removal of this boundary can enable reforms to be pushed a step further.

The first ideological debates in the communist countries began with the discussion on a mutual coexistence of plan and market. Different views and opinions on the relationship between plan and market determined the speed and the extent of the reforms. Socialism is based on public ownership, and this must not be left blind the in reforms.

### *6.1 MARKET AND SOCIALIST PRINCIPLES IN CHINA*

In China, the discussions on a mutual coexistence of plan and market took place from the beginning. During the 1970s and early 1980s China began the first steps of reform by introducing of private ownership in agriculture, resulting in no more collective farming and production plans. Households have been allocated rights to own and use a piece of land and they were allowed to sell at a profit, after having supplied the state a certain amount of grain for a certain price.

The result was a growing significance of the market and individual decision making of the peasants, which led to a series of discussions on the interaction between these two opposites. The discussion was terminated with a formal declaration of the CCP, that the market is a useful supplement to socialist planning

During the 1980's there was still no clear identification or conclusion regarding the mutual coexistence of plan and market. For the conservative, market belongs to capitalism and the plan belongs to socialism. They saw the market as a bird in a cage of the socialist plan. "*In the birdcage economy state controls the market and the market directs firms.*"(Kornai and Qian 2009) For radical reformers the plan is a keystone of socialism. Plan and market are just two different ways to find the right socio-economic allocation.

The debate ended at the 13th Party Congress in 1987, when the CCP adopted the concept of Socialist Planned Commodity Economy, which combines planning and market mechanism. And since 1992 CCP adopted the concept 'Socialist Market Economy' where market was considered a major instrument of both capitalism and socialism.

China has transformed from a centrally planned economy to a mixed economy with market and public ownership. Various opinions on the relationship between the plan and the market played an important role in China. The model, which arose from the clash of views, was "Socialist Market Economy", which emphasizes the role of the market under the control of state's power. Fourteen years had passed before the current model was implemented.

How can the market, the main instrument of capitalism, go together with socialist principles?

Many reforms have stood against the basic principles of socialism. After Mao's death, the leaders were committed to reform, but they had to remain faithful to the fundamentals of socialism. Market encourages competition, maximizing profit, while in socialism public ownership prevails, and issues as redistribution and social security are being dealt. Socialism considers market as one of the instruments in the economy.

This debate has lasted since the beginning of reforms. On the one hand, the conservatives maintaining socialist principles and on the other hand, liberals who are convinced of the importance of the market, they tolerated the economic inequality, and preferred the interest of an individual to the interest of society.

Thirty years of centrally planned economy had forced the post-Maoist to reform the economy. The question was how it should have been reformed? Moderates saw the first stage of communism as a commodity economy with the basic principle of socialism, public ownership, which can co-exist with other types of ownership. Radical reformers again considered socialism as one type of market economy with mixed types of ownership.

In 1990s the discussions on the essence of the shareholding cooperative system was taken place, asking whether the system was public or private. From the discussions eventually emerged the non-state sector in addition to the state sector.

Privatization and corporatization were distinguished. SOEs transformation to the shareholding firms and their shares were being sold on the stock market. The party leaders considered this suitable to socialism, because it attracted investment and capital

into state-controlled enterprises to help the state's budget and meet the social objectives of the government. Majority shareholder of the company was the state, who also plays a role of a watchdog of the company.

Corporatization was therefore very efficient instrument to bring the investment and capital from the non-state sector into the state sector. The government did not permit any greater control and ownership over the state-controlled enterprises to the private sector.

Reform of the shareholding was limited by ideological constraints. The speed of the reform has been reflected in continued discussions and compromises of the moderate and radical reformers resulting in a gradual, dual-track pattern.

## *6.2 MARKET AND SOCIALIST PRINCIPLES IN VIETNAM*

The VCP's leaders also considered the coexistence of plan and market as a hard fundamental question. Discussions on this issue if the changes were in line with socialism or not, shaped the first attempts of the reforms. The 6th Party Congress recognized the advantages of the market. Radicals saw the market as rescuing the inefficient state sector, while the Conservatives saw in the market and liberalization something that disrupts all socialist principles, comparing to the corruption and failed land reform in the South.

Market reforms brought many changes that were inconsistent with the principles of Marxism-Leninism. VCP had to juggle between socialist principles and the principles

of the market to secure its position and not to lose its power during the economic transformation.

7th Party Congress addressed the issue of applicability of socialism in Vietnam. The Congress rejected any capitalist development in Vietnam, but the market mechanism was considered as an instrument that can help to build socialism.

Two extreme views appeared afterwards on the reform and its consequences. First were those who saw the capitalist society as a corrupt regime without taking into account its advantages. The other saw the market as error-free mechanism. As Deng in China, General Secretary Nguyen Van Linh warned against two deviations from the party's reform policy: one was the one who stood in between of these two groups. He warned of seeing too much good aspects on one side and too much bad aspects on the other side for the market.

How can socialism encompass the aspects of capitalism without losing its identity? *“The answer is as follows, reforms in any case do not eliminate the socialist principles because they are the boundaries between communists and noncommunists, socialist and no socialist societies, and revolution and reformism.” (Le Dang Doanh 2002)*

Vietnam has not established a comprehensive reform, which should be divided into certain stages. The strategy was a gradual, experimental method of reform. The first steps took place in rural areas, where the experiment with de-collectivization began.

During the 1980s households worked individually within the production contracts, which were used to set a certain amount of grain at a specified price to be delivered to the state.

Yet the party did not budge from its initial strategy of cooperation and collectivization. The 6th Party Congress fully supported the direction of economic reform from planned economy to a market economy. In April 1988, the party decided on a Politburo Decree No. 10, which clarified the position of a peasant family in the agricultural sector as its basic component. The contracting system gave them the right to use and sell products on the open market.

The contracting system did not mean private ownership. It was just an analogy of the system in China. The 7th Party Congress in 1991 again refused to privatize land. Role of cooperatives have changed from the inspectors over the production to the inspectors over redistribution, taxes, and supplies

Cooperatives still owned capital equipments, but the management and control passed to the individuals.

In the 1990s, a debate on SOEs reform started. Conservatives did not hide the resentment against the SOEs reform. For them SOE meant the hallmark of socialism and should therefore remain under the state control.

Radicals suggested the mutual coexistence of both types of ownership and a gradual reduction of state's role in the economy. They believed that the development of the private sector would not lead to curb public sector, but would rather improve the population living standard.

VCP has therefore decided for the suppression of the plan and to restrict private businesses, and gave them greater scope for independent management. The similar implementation was in the SOEs, where the influence of the state still remained. Basically the changes coincided with changes underway in the neighboring China.

Most SOEs transformed in large conglomerates, where together with other SOE strengthen their position in both domestic market and world market. The 9th Party Congress concluded that the public sector (including SOEs) is the cornerstone of the economy. The main aim is to develop the socialist-market economy, meaning state controlled and state oriented market economy.

Private companies therefore are free in their management policies, but still there are many entry barriers in certain sectors of industry. The conversion of family-run businesses in large multinational companies requires support and funding from the state, which still stand behind the SOEs. This is reflected for instance in the stock market in Ho Chi Minh City, where all firms listed are state-owned.

Vietnam's Economic Transformation follows mainly from the struggle between the moderate reformers and the radical reformers. Radicals wanted to reduce the state role in economy, while moderate reformers see in the private sector an absolute collapse, which will result in massive unemployment and social unrest. Therefore it should be directed to more efficient and profitable SOEs. The 9th Party Congress reaffirmed the middle road between these two ideas and this middle road will continue to shape the policies in the coming years.

## 7. CURRENT POLICIES

### 7.1 CHINA

Investors in China, many of them holding state positions or linked in some way to SOEs, have collected all the gains from the process of privatization. Most of them are listed in the top ten of the richest people and earn benefits from good government contacts. Insider trading and corruption are on the daily basis that leads to a concentration of wealth. Nolan (2004) found that 0.16 percent of the population controls 65 percent of China's \$1.5 trillion dollars in liquid assets. It is no surprise then that between 1985 and 2002 China transformed itself from one of the most equal societies to one of the most unequal in Asia.

Inequality is rising, less jobs in rural areas, local officials are grabbing as much land as they can, and government bureaucrats have intensified political tension in both countryside and the cities. As the journalist Will Hutton found out, the number of people participating in protests grew from 740 000 in 1994 to 3.7 million in 2004. The number of strikes increased from 1 909 in 1994 to 22 600 in 2003 (Chow 2010). The official figures always surely underestimate the actual level of political unrest. But these figures definitely show the need to improve the way how to redistribute the benefits of the growing economy across the regions and classes in China.

Unpaid pensions or unpaid wages were the most fundamental reasons for social unrest. Local governments expressed the need to raise revenues to cover but the central government has not provided sufficient financial resources, even though it has introduced a number of mandatory spending programs, requiring the local government to take on major financial burdens. Sub-national expenditures as a share of total public

spending are very high at around 70 percent. This is higher than other countries within the region; for example, Vietnam it is 48 percent, Indonesia 32 percent and 10 percent in Thailand (Chow 2010).

Local governments' possible responses were to either run businesses to cover the shortfall or to find ways to extract revenue from the local population. The most effective way to do this has been to take rural land from the farmers by paying them low compensation, and reclassify the land for residential or commercial use so they can charge higher prices for the land use. Much of the revenue though ends up in individual pockets.

Massive, underemployed pool of labor is the main driving force of China's aggressive export strategy that is based on low wages, foreign direct investment and access to the US market. China accounted for 10% of world trade in 2007, up from just 4% as recently as 2000. This is an outstanding performance, based mostly on the low margin supply, relatively simple manufactures to the market in the US. With forty percent of exports destined for the US, China had a positive balance of trade of \$232.5 billion in 2006 with the US.

Wages in Chinese industries were just 5% percent of the EU15 average in 2005. But China's industrialization is revealed in the dominance of foreign companies that export abroad. According to the OECD, 55% of all exports are coming from plants owned by foreign firms. 80% of telecoms and electronics exports are also produced by foreigners (Chow 2010). China is still dependent on imported intermediate goods from

the countries as Japan, Korea and Taiwan which is reflected in trade deficit with these countries.

In spite of three decades of remarkable growth, industrialization in China remains shallow. There are just only two real multinational companies as Lenovo and Huawei, no companies in the global top 250 by research and development spending, and no companies on the Morgan Stanley 250 global competitive edge list. China has 22 companies in Fortune's Global 500, but nearly all of them are large SOEs that profit from monopolies. The country ranks 74th in UNCTAD's most recent "Innovation Capability Index".<sup>2</sup>

Most of the Chinese's private firms are micro or small enterprises, and the average lifespan of them is often less than three years. It shows a very different pattern from other East Asian countries and even from India. Part of China's problem can be found in the incentive structures facing local authorities, which view SOEs within their regions as assets to be preserved. SOEs also inherited a legacy of fragmentation from the central planning period, during which firms created a large amount of small scale activities around their core businesses. The resulting fragmentation has cut back off rationalization of entire industries in spite of the efforts of national planners to start large scale business groups on the Korean *chaebol* model. This has also led to poor integration of domestic markets and in various years many provinces have traded more internationally than they have domestically. The share of investment in GDP has been in excess of 35 percent for almost thirty years. It is worth saying in this case that FDI, which produces more than 50% of exports, absorbs only 10% of net investment.

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<sup>2</sup> UNCTAD (2005) *World Investment Report*, Geneva

All around the world production is now highly dominated by few numbers of multinational firms that achieve massive economies of scale through global, integrated supply chains. Modularization of production or in other way product specifications can be cheaply and rapidly shared between the top firms and numerous suppliers and contract manufacturers. *“Modularization can create opportunities for Chinese firms due to their low cost manufacturing, but it has also generated obstacles to technological upgrading and learning that were not present forty years ago.”*(Nolan 2004)

China should confront these problems by protecting less its trade. Through years of massive exports and its phenomenal rates of capital accumulation, China’s comparative advantage still remains low wages of its workers. It has not yet succeeded in developing its technological capacity to the point at which it can compete with the leading firms of nowadays globalized market. China is growing up the technology and value added ladder; machinery and transport equipment now account for 40 percent of its exports. High rates of investment are still the main driving forces of economic growth, it reduces the amount of resources available to raise consumption levels among the poor.

We have shown that the limits of China’s current growth are mostly due to political rather than economic restraints. Increasing levels of inequality, unemployment, social unrest and bad public services, sophisticated bureaucracy and unstoppable corruption are disrupting the path of Chinese growth miracle. Although the government has shown steps to change its strategy away from “growth at any price” towards a stronger emphasis to fairness and equity, there is still a long way to go to reach the peak.

## 7.1 VIETNAM

Vietnam has failed to manage problems that many East Asian countries had to deal with before. Examples can be an over-reliance on hydroelectric power generation or the congestion that haunts the city of Hanoi and Ho Chi Minh. In fact, both Ho Chi Minh City and Hanoi stand out of the league of Asian urban centers due to their lack of effective public transport. Nowadays the city planners regret not to start thinking of the subway system much sooner. Now expecting the subway to be finished in two decades would be very naive.

Another issue that comes to mind here is the sewer system. The widespread flooding, that causes every season a lot of headaches and hardship to inhabitants of these two biggest cities in the country, could be controlled, but again, the city's response has been fruitless. Many cities in East and South-East Asia have dealt with these kinds of problems very effectively, but somehow Vietnamese government seems to lag behind in addressing fundamental and predictable challenges. How will it react in the face of an unforeseen crisis?

According to World Bank's latest study, Vietnam scored lower than all East and Southeast Asian countries except Indonesia in government effectiveness, voice and accountability regulatory, and quality of law (Kornai and Qian 2009).

Vietnam's ranking in the category of "governance effectiveness" declined between 1996 and 2010. But it does not mean that Vietnam did not concentrate on this area, it just means that other countries performed better and their improvement were much faster.

By replacing the bureaucratic apparatus or reducing the number of ministries may produce some effective gains, but absolutely more will be gained by limiting the power of the state and its functions. The state should focus on key areas only.

In recent years the donor community has poured large sums of money into existing administrative apparatus to help public administration reforms without success because the existing apparatus did not fundamentally change anything of what it does. The Vietnamese government's own reform has been a bigger success, especially the Enterprise Law that set up the essential basis of the market structure. Vietnam is now facing new challenges that need much more elaborate solutions. *"The country needs to reform education system, healthcare, resolve the infrastructure crisis, and meet the challenges of urbanization and environmental degradation, this will require better government, not just less government."*(Le Dang Doanh 2002)

If Vietnam wants to achieve its ambitious development objectives, the economy must keep pace with other East and Southeast Asian countries. continue to perform high rate of growth for the next several decades. This has been shown as a very difficult objective to achieve for many Asian dragons. And indeed most of the developing countries started to slow down their growth when they reached a certain level of wealth. And Vietnam, of course, will approach this level soon. Vietnamese politicians must therefore ask themselves: how can Vietnam sustain its phenomenal growth? *"It should be clear that the only way to achieve a sustained high rate of economic growth for several decades more is to identify the sectors with the most growth potential and provide them with the environment and inputs needed to thrive."*(Rodrik 2007) The Vietnamese economy is driven by private and the foreign

invested sectors. These sectors are most likely to ensure the prolonged economic growth on which Vietnam's future depends. However, the government is not providing these sectors, especially the private sector, with the conditions that is needed to guarantee their success in the future.

Government industrial policy remains biased in favor of the sector that objective analysis reveals is the least competitive, generates the fewest jobs, and delivers the lowest growth rate. This is to place the economy against the necessity to sustain a high rate of growth for the next several decades, it is no different from a general who sends his weakest soldiers first to the war.

## 8. CONCLUSION

The growth theory is now much more sophisticated and powerful as it was. Even though the regression models can pick useful correlations and significant variables, but from the experience of the countries we can see that none of the policies is always applicable. Since the original ten rules of Washington consensus and its modification “the post-Washington twenty”, the economist thought they knew how to make growth happen. But the results were quite disappointing.

If the countries as Pitch Land were undergoing high rate of growth and Lucky Republics were stagnating, there would be no dispute about the recommended policy rules. Now the basic reform policies are under attack and suspicion of not having the key role to ignite economic growth.

My thesis showed that China and Vietnam have been very careful in their reforms in transition from the centrally planned economy to socialist-market economy. The reform pace and the direction have been shaped by a decade of long discussions and debates between moderate and radical reformers. In both countries it resulted in a gradual, step by step, experimental and dual-track pattern of transition.

The need of political sustainability dictates the timing and structure of the reforms. One important lesson can be made from the reform path of both countries. It is the step-by-step partial reforms, which can help to implement the changes gradually to the areas where possible with an opportunity of a quick outcome. That would strengthen the following political support to the reforms needed.

Finally, we need to realize that the same policies applied to all the countries do not surely lead the countries to the same economic level. The mentality and preferences of the citizens are different and the response to the policies applied can be various. The growth policies are context specific and we cannot implement the policies without taking into account the knowledge of the local opportunity and constrain conditions.

The fundamental differences of China and Vietnam from other transition economies are the Communist parties that had experienced many extremely long and depleting wars in their history. The parties are deeply rooted in the whole society, which is poor and less educated than their European counterparts. Vast majority of the population had worked in agriculture before the reforms. Thanks to thousands of years of feudalistic socio-political system, the parties are more efficient implementing political control. The marginal cost of political control is lower than in Eastern European countries.

These differences can tell us that a revolution in a sense of Eastern European post-communist countries is not going to happen, due to the low desire from the population and the low marginal cost of political control. The Communist parties are strong and oppose every possibility of losing power in the country. China and Vietnam are the real proof of economies that are undergoing the market-oriented reforms without drastical changes in their political system.

However, the great issue to be resolved is the connection among the powers. Legislative power, executive power and judicial power are not perfectly separated. It is a fundamental and a necessary condition for democracy since John Locke and both

China and Vietnam should not postpone these political reforms. Democracy does not have negative effect to growth as we could see in many papers from Rodrik (2005) or Minier (1998). They state that democratic transition does not bring about adverse economic consequences.

*“The leaders cannot make correct decisions on policy matters unless they are provided with a comprehensive, objective analysis of the situation and possible responses. This kind of analysis can only emerge from constructively critical debate. Therefore, the government must actively encourage constructive criticism, and the sharing of alternative viewpoints.”(Minier 1998)* This means from all sides, legislative power, judicial power, and also press.

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## TEZE BAKALÁŘSKÉ PRÁCE

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Garant studijního programu Vám dle zákona č. 111/1998 Sb. o vysokých školách a Studijního a zkušebního řádu UK v Praze určuje následující bakalářskou práci

Předpokládaný název BP:

**The Theory of State in Totalitarian Economies**

Charakteristika tématu, současný stav poznání, případné zvláštní metody zpracování tématu:

*Economic theory of the state is an analytical framework for examining the role of institutions, taxation and law in the creation of economic models. In totalitarian economies the role of state is bigger than in democratic countries. Although, after the fall of Berlin wall, „Washington Consensus“ acted in favour of open markets and limited government involvement in business, the economic downturn has opened the door to a seemingly alternative ideology to the West’s liberal-market approach. Even the American government is redrawing the boundaries between the state and the economy. The 20th century was the “American Century”, the 21st belongs to Asian countries, especially China. The leading country always offers a new framework to the world, and in the case of China its success is apparently proved by its booming economy.*

Struktura BP:

**Abstrakt**

*First part contains general characteristics about authoritative and totalitarian régime, differences between these régimes, opinions and knowledge of scientists dealing with this issue and also confrontation of both régimes. Another part is about economic transformation in Asian countries, especially China and Vietnam. Further this thesis brings near political system and structure of government and economy of the present totalitarian countries. I discuss here whether the systém works and will work in the future or the economies need to be reformed. What is the role of the state in these countries? How monopartism or bipartism affect the economic systém of the country?*

**Osova**

- 1) *Defenition of totalitarian economy*
- 2) *Diferences between totalitarian economies and capitalist economies*
- 3) *China's economic tranformation*
- 4) *Vietnam's economic transformation*
- 5) *Role of state in China and Vietnam*
- 6) *Monopartism, Bipartism*
- 7) *Conclusion: What are the limits of boundaries between the state and economy?*

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