CASE STUDY

Understanding a Development Miracle: China

From 1978 to 2006, the economy of China grew at an average rate of approximately 9% a year, an unprecedented achievement for any economy in history, let alone the world's most populous nation. China's income per capita by 2006 was more than five times higher than it was in 1978. Growth was three times the rate that would be considered respectable by the recent standards of most low-income countries.

China has also experienced the world's most dramatic reductions in poverty. An independent World Bank estimate by Shaohua Chen and Martin Ravallion has the number of poor in China falling from 53% in 1981 to just 8% in 2001. This means that 400 million fewer people were living in extreme poverty in a span of just two decades. Reductions in extreme poverty in China are far faster and greater than anywhere else in the world.

For such a stunning record, the roots of China's success remain a source of disagreement. All the major traditional and new schools of thought on development want to claim China as their most important case in point. China is hailed as an example of the benefits of markets, trade, and globalization. There is no doubt that manufactured exports are key to China's growth, and market incentives have played key motivational role in business decisions. But China has also adopted active industrial policies, pushing exports of increasingly higher skill and technology content, and it started its period of rapid growth around 1980, more than a decade before significant trade liberalization. Moreover, much of China's growth in the 1980s and 1990s was due to rural township and village enterprises, which have had a quasi-cooperative character. There has been less privatisation of state-owned enterprises than in most developing countries (in some countries, privatisation has been made to work, but in others, privatisation has amounted to little more than the theft of public assets). In the meantime, countries in Africa, Latin America, and elsewhere that have most closely followed the free-market model have generally not done particularly well. There have been many special explanations for China's remarkable success. Many of them contain part of the truth. Let us review some of the explanations.

The presence of regional "demonstration" models has been crucial. Japan was emulated by other countries in the East Asian region. Hong Kong provided an additional example for China, as did China's arch-rival Taiwan. Taiwan, Hong Kong, and South Korea focused on export-oriented industrialization at a time when world trade was growing rapidly. Then, by the late 1980s, the locus of regional growth shifted to China as investors began to pour investments into China in large part because of the appeal of its eventual market of more than 1 billion consumers. Although the market was limited at first by both low incomes and government policies, early investors found high incentives to export from several special economic zones on the southeast coast. These investors discovered that China offered very cheap labour with unusually high skills and work habits for its income level. Once early investments built up a sufficient critical mass, benefits of concentrated economic activity kicked in. The more producers located in China, the greater the benefits for an increasing number of suppliers to operate there. In the meantime, when wages began to rise, companies could set up production farther west, or migrants from the west could move to the new industrial centres. Given China's population of hundreds of
millions of low-income farmers, expectations were formed that this process of wage restraint could continue for an extended time.

The central planning of China's first decades after its 1949 revolution was by most measures a failure. Industry was highly inefficient. As many as 30 million people died in a late-1950s famine caused by poor central planning decisions and political pressures that led party and government officials to regularly overstate the harvest prospects. As Amartya Sen stresses, famines rarely occur in democratic countries with a free press. Such disasters were only partly offset by the early and on-going emphasis on basic health and education in China and then on reductions of fertility through China's one-child policy. There has been considerable debate about whether rapid growth in other East Asian countries is the result of capital accumulation or productivity gains. Paul Krugman and others have concluded that South Korea and other Asian Tigers grew more from investing heavily in capital assets such as machinery and factories than by improved worker efficiency. But for the case of China, Zuliu Hu and Mohsin Khan concluded that productivity gains explained more than 42% of China's growth in the 1979-1994 period and that productivity had overtaken investment by the early 1990s as the largest source of growth. This was considered surprising in part because of the breath-taking pace of capital investments in China. But on the other hand, when China's rapid growth began in the late 1970s in the areas close to Hong Kong, while it was clear that a large volume of investment funds were flowing from capital-abundant Hong Kong (still a British crown colony) to capital-scarce China, the bigger story was the flow of productive ideas over the Hong Kong border, a barrier that had long prevented the transfer of both capital and know-how. Of these two factors, it often seemed that the ideas were more important than the finance.

In a separate study, Ashoka Mody and Fang-Yi Wang of the World Bank examined the causes of industrial growth in China and concluded:

> Although industry-specific features—the degree of specialization and competition—had some influence on growth, much of the action came from region-specific influences and regional spill overs. Regional influences included the open-door policies and special economic zones that successfully attracted investments from overseas Chinese to particular locations. Existing regional strengths, especially high-quality human capital and infrastructure, also contributed to growth. Our results illuminate the interplay between conditions conducive for growth—for example, the contribution of foreign expertise is greatly enhanced by available human capital.

Government played off potential investors who wanted access to China's billion-plus consumers, demanding and getting extensive technology transfer, public and private Chinese business partnerships, local content, and other concessions in exchange for the right to sell to Chinese citizens. However, Wing Thye Woo concluded that most of China's growth came from the reallocation of labour, particularly from agriculture to other activities, and that total factor productivity progress was much lower, on the order of 2% per year.

In China, the way that market incentives were introduced and used seems to have been almost as important as the fact that they were introduced at all. China's approach has been the opposite of that of many eastern European countries such as Russia and Poland, which opted for a "big bang," a sudden comprehensive changeover to a free-market. China has introduced new and transitional institutions that exist side by side with previous institutions of central planning for extended periods. In the former Soviet Union and Eastern Europe, central planning was abolished almost immediately, and economic depression, with drops in output of up to 50%, ensued before gradual recovery. In contrast China kept
the central planning system partially intact for an extended period. Previous quotas for buyers and sellers at fixed planned prices were maintained. Reform was instead introduced on the margin. After filling their quotas, producers were free to buy and sell at market-determined prices; re sales were generally not prohibited. This “dual track” system stimulated the allocative efficiency of a more competitive market economy and created strong incentives for firms to improve efficiency and increase output.

Moreover, while in other transition and developing countries state-owned enterprises (SOEs) were sold off to private investors fairly quickly, in China these remained in government hands for an extended period. The government tried to reform them internally. But at the same time, China has allowed and encouraged a new, more efficient sector to grow up around them. In recent years, China has privatized or closed many of the smaller SOEs. Many larger SOEs continue to operate in a relatively inefficient manner. Eventually, as employment opportunities continue to expand, more of the larger SOEs can be privatized or closed.

Further, for the first nearly two decades of reform, from the late 1970s to the mid-1990s, at the local level, township and village enterprises (TVEs) were encouraged. Vaguely owned by local government, private entrepreneurs and employees of TVEs also held “vaguely defined” property rights. These TVEs accounted for a very large share of industrial output growth in China. Finally, after the Chinese economy had grown nearly fourfold, the majority of these TVEs were privatized in the late 1990s. But the TVEs played a unique role in spurring growth and spreading the benefits of development to rural areas. It should be noted that early reforms favoured agriculture in the rural areas where most of the poor live, and poverty fell as income rose. From the late 1980s on, the terms of trade shifted toward industry, and the rate of poverty reduction fell. In 2004, over half the population was still involved in agriculture.

As outlined by Yingyi Qian of the University of California-Berkeley, China’s transitional institutions have served a dual purpose: to improve efficiency while compensating the losers (and thereby preserving legitimacy or at least reducing the chance of political backlash). Provided that the quotas were enforced—and for the most part they seem to have been in the transition in China—the dual-track allocation system protected the interests of those who had benefited from and planned on receiving inputs at fixed, low prices. As a result, these agents did not oppose or undermine reforms and indeed could benefit further from them to the degree they could learn to produce more efficiently and operate in markets effectively. The system was largely phased out only many years later, after the economic landscape had changed dramatically.

The “vaguely” local-government-owned TVEs provided protection for investors who feared the hostility of the government to private property and worried about expropriation. The image that these companies were owned by the township or village protected the de facto private owners. Once reform proceeded to a certain point, these de facto owners were able to assume ownership in exchange for considerations to local government, and taxes replaced direct revenue transfer out of the TVEs. Government also allowed anonymous banking accounts for a long transition period, to credibly constrain the ability of the government to arbitrarily impose high individual taxes on successful entrepreneurs. Qian judged the program a success despite the fact that this diverges from what is considered normal best practice in advanced Western countries.

Finally, for peasants in parts of China where the rural sector has done well, earlier land reforms have been among the causes— with the reforms giving greater incentives to individual farmers. Land reform
has been notoriously difficult to implement in other parts of the world. Remittances from migrant workers have fuelled a service-sector boom in some rural areas, and prices received by farmers have generally risen, particularly near urban areas. Moreover, the environmental crisis in China is reaching epic proportions. A majority of the most highly polluted cities in the world are located in China, and resulting health problems are growing. Water resource problems, erosion, and loss of habitat undermine the prospects for sustainable development. In parallel, product safety standards are low, and their regulation is lax. Although the excess of China’s exports over its imports continued to skyrocket, by mid-2007, highly publicized scandals concerning the safety of food, drugs, and other consumer products threatened the international public image of Chinese-made products. China’s regulatory institutions will need to catch up with the progress made in other aspects of national economic development.

The huge indebtedness of the SOE sector and other public debt may eventually lead to a significant financial crisis. Moreover, China is quite homogeneous, overwhelmingly populated by members of the Han ethnic group. In Africa and other parts of the world, ethnic diversity is associated with slower growth, though only in countries that also have incomplete or non-existent political freedoms. Clearly, China is lacking in many freedoms. There may be limits to the ability of other countries to carry out China’s brand of centrally-designed and implemented policies for transition and directed growth when either broader democratic freedoms are in place or greater ethnic diversity is present. Finally, China, like much of the rest of East Asia, has a relatively poor endowment of natural resources. Many development specialists have concluded that this lack is actually more of a benefit than a drawback. In terms of geographic advantages, East Asia is also much less plagued than Africa and other developing regions by problems such as malaria and other tropical diseases for which medicines are not readily available, the difficulties and disadvantages of tropical agriculture, and the problems of land-locked countries.

In sum, China does change the way we think about development. It assures us that the East Asian miracle is not a fluke due to special local factors in economies such as South Korea and Taiwan. It gives us much greater confidence when we say that “real development is possible.” On the other hand, there are clear limits to the ability of other developing regions to emulate the success of China.