CHINA'S REFORMED ECONOMY

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It is easy to identify China's main economic achievements in connection with the country's transition to a new economic system: a GDP growth rate perhaps as high as 9 to 10 percent per year since around 1980; an eightfold increase in per capita income; and a fall from 50 to 10 percent of the share of the population living in "absolute poverty". This last category is then defined as individuals living on less than one dollar a day. However, it is also important to be clear about the resource costs connected with China's rapid growth path as well as lingering, and in some fields increasing, social problems.

Nature of the economic reforms

Since the late 1970s, when the economic reforms started, the sequential privatization of collective agriculture farms, Town and Village Enterprises (TVEs) and a large number of state firms has drastically changed the ownership structure in the country – a development accentuated by the entry of new private firms, domestic as well as foreign. As a result of these developments, about 60 percent of the aggregate production in China today seems to take place in privately controlled firms. China's economic system has, however, changed dramatically also in other dimensions than the ownership structure. Economic decision-making has been decentralized from government authorities to households (in the case of consumption) and to firms (in the case of production and investment); command has, to a considerable extent, been replaced by economic incentives; administrative processes by markets; monopoly by competition; and autarky by internationalization, codified in China's entry into WTO in year 2001. Broadly speaking, the Chinese economy is, however, more open on the export side than on the import side – not unlike Japan and South Korea some time ago. Clearly, the restrictions of foreign competition on domestic markets (even by foreign firms with production in China) are in conflict with the government's recently expressed ambitions to pursue a more ambitious competition policy.

Deficient factor markets

Factor markets have, however, not been reformed to the same extent as product markets. This shows up in labor markets, financial markets as well as the market for land. The labor market has a pronounced insider-outsider character: employees in state firms are privileged in terms of wages and, even more, when it comes to various social benefits – a feature which limits the flexibility of the labor market. The insider-outsider character of the labor market in urban areas is accentuated by the household registration system, the urban *hukou*, which requires a permit for living in urban areas. While the implementation of the *hukou* system has recently been softened, it continues to discriminate against migrants who have actually settled down in urban areas without permits. Indeed, the approximately 140 million individuals living in cities without permits today – the so-called "floating population" – are the most pronounced "urban outsiders". This is not only reflected in their relatively low wages, but often also in particularly unhealthy working conditions, as well as in their limited access to affordable human services such as health care and education.

Financial markets are even less reformed, and less developed, than labor markets. Indeed, the poor functioning of financial markets is a basic weakness of the economic system in China. For instance, state banks still dominate the market for loans and, during the last decades, they have allocated about two thirds of their lending to public-sector firms, mainly SOEs. Since the loans have often been quite "soft", they have in many cases turned out to be non-performing (neither being amortized nor paying interest). Although the emergence of informal credit and cap-

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ital markets has mitigated the discrimination of private firms, the dual nature of financial markets in itself is a distortion. New capital injections to state banks by the government, and a shift of non-performing loans to special asset management institutions have, at least temporarily, "cleaned" the balance sheets of state banks. The non-performing bank loans seem to have been reduced from about 30 percent to about 10 percent of the stock of bank lending. But a permanent removal of major risks of financial instability naturally requires that state banks discontinue their habit of providing soft loans to state firms. Equally important: a higher quality of bank lending is necessary for improving the allocative efficiency of investment and production, which has for a long time also been harmed by the dominance of the government sector in the very thin markets for shares and bonds.

The market for land is even more dominated by the public sector, simply because all land is owned by the public sector and leased to private agents. Naturally, this feature of the economic system has particularly important consequences in agriculture, although the present arrangements are vastly more efficient than the old system with collective agriculture communes. Since land-lease contracts are less "complete" than ownership contracts, the ownership structure for land is bound to hamper both investment decisions in existing farms and the consolidation of land holdings, and hence also the possibilities of exploiting potential returns to scale in agriculture. Land-lease contrasts are also less useful as collateral for borrowing than ownership contracts. All this means that China pays a heavy price for its lingering socialist ideology when it comes to the ownership of agricultural land. While Deng Xiaoping is famous for his metaphor that "the color of the cat does not matter as long as it catches mice", the color of land contracts in agriculture does seem to matter.

A network economy

Deficiencies in the implementation of the "rule of law" are another major weakness of the economic system in China, although the legal system in the economic field has gradually improved during the last two decades. To some extent, the remaining deficiencies are compensated for by informal networks based on personal relations, *guanxi*, which may be regarded as a Chinese version of "social capital". Clearly, these networks facilitate economic transactions (partly through reduced transaction costs) among network members, which often include not only businessmen but also local politicians and public-sector administrators. The network system means, however, that China is an insider-outsider society also in the business sector; individuals outside the networks are disfavored. The clientele-like relations between representatives of the public sector and individual businessmen also open the gates for corruption, since some of the representatives are in charge of regulations and permits of various types.

"Asset stripping" in connection with the privatization of firms is another example of corruption in China – often favoring either the management of the firms or public-sector administrators, or both. During the transition period, such asset stripping, like some other types of kick-backs, has probably speeded up the creation of a class of private capitalists, which is likely to have been conducive to entrepreneurship. However, if corruption becomes a permanent part of the Chinese economy, it is likely to have negative consequences for the allocative efficiency of the economy in the long run; at least, this is a general experience in many other countries. Moreover, it is difficult to get rid of corruption as long as politicians and public-sector administrators have something to sell – like permits of various types. This is an additional argument for further deregulation of the Chinese economy, in particular by reducing the requirement of discretionary permits of various types.

How, then, should we characterize China's economic system today? Some observers use the term "state capitalism". This is, however, a rather misleading term since more than half of the aggregate production is performed by private firms. Moreover, high household savings (20 to 25 percent of the disposable income) and large plowed-back profits in private firms are likely to gradually increase the private share of the ownership of firms and assets. The term "market socialism", launched by Oskar Lange and Abba Lerner in the 1930s, is misleading for the same reasons. I would simply characterize the system as a "mixed economy", although with some *specific* characteristics such as (1) a relatively high openness to the outside world (as compared to other large countries), (2) more private ownership of firms than of assets (in particular land and financial assets); (3) considerable political and bureaucratic interventions in state enterprises; (4) poorly developed factor markets, in particular the financial markets; (5) tight networks among business men partly replacing the ”rule of law”; and (6) a pronounced insider-outsider division in society at large – in labor and capital markets, in the business community as well as in the case of social arrangements.

Inefficiencies of the growth strategy

In spite of China's extraordinary success in terms of GDP growth, there are strong indicators of serious limitations in the *efficiency* of the growth path: the resource costs have been relatively high. One indication is the high aggregate investment ratio, today about 43 percent of GDP, which has resulted in a very high marginal capital-output ratio of 4 to 4.5, indicating rather low capital productivity. The marginal capital-output ratio has also gradually been rising over the last two decades, which may indicate falling capital productivity. As compared to the huge investment in real capital assets, the investment in human capital looks relatively modest around 4.5 percent of GDP, of which less than 3 percentage points are financed via government budgets. Although a high rate of capital accumulation is natural for a country that gives high priority to economic growth, the division between real capital assets and human capital looks quite lopsided, the proportions being ten-to-one.

The huge consumption of energy, raw materials and environmental values is another indication that the growth path is highly extensive (resource-using), largely a result of distorted prices on such products. Although China has gradually become a more efficient user of energy, the country seems to use twice as much energy per unit of output as other countries (Bergsten 2006, 34). The extensive growth path in China is also reflected in the rather moderate rate of "multi-factor productivity growth",[1] which seems to have been about 1.5 to 2.5 percent per year during the transition period – a measure of technological and organizational improvements.

My tentative conclusion is that China has a great deal to gain from moving to a more intensive growth strategy by shifting resources from investment in real capital assets to human capital; increasing the flexibility in factor markets; raising the relative prices of energy and raw material (for final users); and limiting the enormous tear on environmental resources, in particular land, air and water. Less real-capital intensive production would also boost employment.

Large income gaps

Uneven regional economic development is another important aspect of the Chinese growth path. While the GDP growth rate in some provinces has been more than 12 percent per year since around 1980, it has been only half as high in others. As a result, per capita income in the most developed provinces (and large cities) is about seven times as high as in the least developed ones. Indeed, the geographical differences are so large that China resembles a *continent*, consisting of both semi-industrial countries and some of the poorest countries in the world, rather than an ordinary nation state. Another aspect of the geographical income divide is that per capita income is about three times as high in cities as in the countryside. These geographical divides are largely the result of the specific economic policy strategy followed by the government. One example is the selective opening of the Chinese economy for foreign direct investment through the Special Economic Zones in some costal provinces in the 1980s. Other examples are the concentration of infrastructure investment to these provinces and, until recently, the unfavorable price and tax system for farmers (except during the early reform years in the early 1980s).

The income gaps in the country have, however, widened also *within* narrowly defined geographical areas, such as within municipalities, largely in connection with the increased return on human capital. This is to a considerable extent a side effect of the shift to an economic system based on economic incentives rather than command – without deliberate policy actions to mitigate the distributional consequences. For instance, the Gini coefficient for the overall distribution of household income seems to have increased from 0.28 in 1980 to 0.40 to 0.45 today.

[1] The total factor productivity growth *excluding* investment in human capital and reallocation gains in connection with the shrinking agricultural share of the economy (see Lindbeck 2006, 32–33). Total factor productivity (TFP) growth seems to have been 1.0 to 1.5 percentage points higher than multifactor productivity growth, as a result mainly of the huge reallocation gains.

What explains China's economic success?

It is not easy to say which specific features of China's new economic system that have been most conducive to the country's impressive growth performance from the late 1970s. A trivial, but possibly correct, answer is that the success depends on the *combination* of reforms in all the earlier mentioned dimensions of the economic system, since this combination seems to have released earlier repressed individual initiatives. When it comes to GDP growth, the release of individual incentives has obviously dominated over the brakes on the economic efficiency of the remaining weaknesses of the economic system. It is, however, also tempting to hypothesize that the *gradualism* and the *experimental nature* of the reforms have been conducive to the economic success. In particular, gradualism (including the slow reduction of the overstaffing of SOEs) seems to have helped China balance job creation and job destruction much better than in transition countries pursuing a Big Bang strategy. This may very well be a main explanation as to why China, in contrast to many other transition economies, avoided negative consequences for GDP growth during the early period of transition, and a related explosion of unemployment.

As emphasized by Presad and Rajan (2006), for instance, the gradualist strategy could run into problems in the future. Major coordinated reforms may be crucial for further economic progress in some cases, for instance in order to build up market supporting institutions, improve the functioning of factor markets, reduce discretionary government interventions in state enterprises and mitigate corruption. There is also the risk that a prolonged, gradualist reform process finally comes to a halt as a result of the build-up of strong interest groups and the emergence of related "veto points".

Consequences for the outside world

In the future, China's emergence as an important actor on international markets may very well be regarded as a major event in modern economic history – possibly comparable to the entry of the United States into the world markes in the late 19th and early 20th century. In several respects, this is likely to be economically favorable for developed countries. In particular, new opportunities are opened for these countries through the gains from trade because of the huge difference in factor proportions between China and developed countries. After all, the gains from trade tend to be larger, the more the factor proportions differ among trading partners. The situation is more problematic for a number of developing countries with similar factor proportions as China, and probably also for some transition economies in Eastern Europe and former Soviet Republics. For all these countries, China is likely to become a serious competitor, in particular in the field of labor-intensive products.

However, some observers argue that China today is also a large producer of human-capital intensive and high-tech products and that developed countries are therefore threatened by stiff competition from China also for such products. This view is based on a misinterpretation of official trade statistics, however. It is true that China exports large volumes of products with considerable high-tech content, such as video recorders, television sets and mobile phones. But the high-tech content of these products consists of intermediary products *imported* from other countries. The domestic value added in China of these exported products is, in fact, based on low-skilled labor and low-tech production methods. Indeed, the domestic value added of the export of electronic and information technology products seems to be no more than about 15 percent of the export value of these products (Branstetter and Lardy 2006). Moreover, in 2003, the domestic production of semiconductors is reported to have been less than a tenth of the value of the imports of such products (Baijia 2004).

Today, China is thus most appropriately regarded as a major *assembly platform* for imported high-tech components – indeed, the major platform of this kind in the world. As long as China buys most of its high-tech intermediary inputs from developed and semi-developed countries, it is not likely to be a large scale threat to high-tech firms in other countries.

Naturally, in a long-term perspective, China will probably considerably expand the production of high-tech products and, in this connection, gradually upgrade its position in the international hierarchy of production tasks. Indeed, the Chinese authorities have expressed a concern of just being an assembly platform for foreign firms, rather than having a vital indigenous technological development. If China succeeds in upgrading its production in domestic firms, both the traditional product cycle and the international "task cycle" (i.e. shifts in the international location of production tasks within vertically integrated production processes) is likely to be speeded up. Developed countries that are able to continue shifting to new and more sophisticated products and production tasks do not have much to fear from this development, although certain groups of individuals in these countries are bound to lose, possibly not only in relative but in some cases also in absolute terms. Countries that are not flexible enough are likely to run into serious problems – with a likely boost of protectionist pressure from groups in such countries that find themselves threatened.

Social challenges

The huge increase in per capita income for a billion of the poorest people in the world, and the drastic reduction in the number of individuals in China living in "absolute poverty", do not only constitute an important *economic* achievement. These developments also imply important social progress. However, the social development in China has been disappointing during the reform period in several other respects. One important reason is that the previous social arrangements, tied to work places *(danwei),* broke down at the same time as citizens became more exposed to market risks. Moreover, social benefits tied to the individual's work place do not sit well in a market economy, where it is important that social benefits are portable across workplaces.

Clearly, the political authorities in China are fully aware both of the serious social problems in the country and the defects of exiting social arrangements: the huge income gaps across geographical areas and among individuals, the lack of income security for the majority of the population and the uneven distribution of the provision of human services such as education and health care. Indeed, at the 11th Congress of the Communist Party in early 2006, the leadership announced a shift from the one-sided emphasis on GDP growth to the new ambition to create a "harmonious" society with greater concern for regional and social balance, and hence for future social stability. It remains to be seen to what extent, and how fast, this announcement will be reflected in actual policies.

New social arrangements?

Although the new social ambitions so far have been more pronounced in the rhetoric than in actually pursued policies, China has clearly entered the route towards new social arrangements, indeed towards modest welfare-state institutions. However, a basic weakness of today's social arrangements is the one-sided emphasis on the interest of urban insiders at the expense of broader population groups, in particular individuals with low-income and the rural population in general. However, when dealing with this issue, it is important to remember that the potentially appropriate arrangements in the social field differ considerably between urban and rural areas. In the cities, the authorities could provide better income security "simply" by widening the group of citizens covered by social insurance, such as unemployment insurance, health-care insurance and retirement pensions – although this may require less generosity towards the most privileged groups today. Social insurance of this type is less operational in rural areas. Indeed, unemployment and retirement (and often also income) of individual households in agriculture are often even difficult to define and document. For the agriculture population, it may, therefore, be easier to rely on crop-failure insurance and lump-sum transfers rather than ordinary (general) income insurance. As a comparison, it was rather late in their development process that today's developed countries extended income insurance to the agriculture population.

The provision of human services suffers from the same types of problems as the arrangements for income protection. Once more, the urban insiders are favored as compared to the rest of the population. Indeed, the distribution of education and health care seems to be at least as uneven as the distribution of household income. The basic problem is the way in which such services are *financed*. For instance, the government budget today finances only 63 percent of total spending on education in the country. The rest is mainly financed by various organizations, including firms and organizations connected with firms, but also by out-of-pocket money from households (in particular in the case of higher education). Even more striking, in the case of health care, public budget financing only accounts for about 40 percent of total spending, and the remaining part is mainly financed by out-of-pocket money from households.

It is easy to understand that low-income groups have serious difficulties in getting adequate schooling and medical care with these financial arrangements. Moreover, since local rather than national authorities are responsible for public-sector financing of education and health care, the huge variations in tax revenues across local authorities make the provision of such services highly uneven across geographical areas. It is difficult to see how these problems could be effectively dealt with without a shift of a large part of the financing of education and health care from private individuals to the public sector (through taxes or a mandatory insurance premium), combined with a huge expansion of central government transfers to poor local governments.

Social lessons from developed countries

When launching more ambitious social policies, China could learn a great deal from the experiences in developed countries. On the "positive" side, the main lesson might be that it is possible to provide quite ambitious social arrangements without endangering a continuation of per capita economic growth. There are, however, important reservations to this observation. If the generosity of income insurance exceeds certain limits (which are difficult to empirically determine in advance), the systems may not be financially viable in a long-term perspective. One reason is that serious problems of moral hazard may emerge – an aspect that politicians in developed countries have usually underestimated, or even entirely neglected. In Europe, this is, for instance, reflected in long spells of unemployment, high sickness absence and a large number of individuals living on highly subsidized early retirement. Such moral hazard problems may be particularly severe, if *social norms* against exploiting various benefit systems weaken over time when more individuals choose to live on such benefits (Lindbeck 1995). China is well advised to be aware of such problems when new social arrangements are considered today.

In developed countries, serious efficiency problems have also emerged in the field of human services. For instance, most developed countries are concerned about low quality in large parts of their school systems. In China, the corresponding problem is particularly serious for poor sections of the population. There are also strong indications of vocational training being poorly developed in China, while university education is rapidly expanding. It would seem that China is approaching a pronounced duality (polarization) in terms of schooling, with a rapidly expanding group of individuals with a high academic education combined with a large group of individuals with both little theoretical and vocational training.

Developed countries today also experience serious efficiency problems in the field of health services – in some countries largely in the connection with rationing and queues, in other countries in the form of cost explosions, partly as a result of ex post moral hazard (such as unnecessary expensive medical examination and excessive medication and surgery). China has already encountered similar efficiency problem – in addition to the poor access of health services for low-income groups. The efficiency problems are reflected, for instance, in extremely high prescriptions of drugs and the application of sophisticated and often hardly necessary surgery for a small fraction of the population (Eggleston et al. 2006).

The complications concerning financing, incentives (including moral hazard) and efficiency of social arrangements hardly constitute a basis for delaying radical reforms in these fields in China – either for income protection or the provision of human services. However, the complications call for caution to avoid future "overshooting" of the generosity of the benefit levels – and related risks of conflicts between social and economic ambitions. My interpretation of the international experiences in this field is, however, that the risk for serious conflicts between social ambitions and concern for efficiency/growth does not only depend on the *level* of social spending, but largely also on the *method* through which social policies are pursued.

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