CAPITALISM WITH CHINESE HARACTERISTICS

Since 1978, the Chinese economy has grown phenomenally. This is not in dispute. By exactly what mechanisms has China managed to grow so fast? There is more room for debate on this question. A widespread view is that private entrepreneurship, financial liberalization, and political reforms played a minor role in explaining China's economic takeoff. Based on archival research and survey data, this book offers an alternative view: Private entrepreneurship, facilitated by access to capital and microeconomic flexibility, was at the center of China's takeoff in the 1980s. The political system, then as now, was authoritarian, but it was moving in a liberal direction. China lacked well-specified property rights, but it substantially improved security of proprietors. But given this initial success, how then to explain the substantial distortions in the Chinese economy today? The key to getting the China story right is to recognize the existence of two Chinas – an entrepreneurial rural China and a state-controlled urban China. In the 1980s, rural China gained the upper hand, and the result was rapid as well as broad-based growth. In the 1990s, urban China triumphed when the Chinese state reversed many of the productive rural experiments of the previous decade. While this reversal does not show up in the GDP numbers, it shows up in the welfare implications of growth. Since the early 1990s, household income has lagged behind economic growth and the labor share of GDP has fallen. Social performance has deteriorated. The directional liberalism of China in the 1980s and the emerging India miracle today debunk the widespread notion that democracy is automatically anti-growth. As the country marks its 30th anniversary of reforms in 2008, China faces some of its toughest economic challenges and vulnerabilities. The long overdue political reforms are required to improve governance and accountability and to put China on a sustainable path of development.

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Capitalism with Chinese Characteristics

Entrepreneurship and the State

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This book is dedicated to Nian Guangjiu, Zheng Lefeng, and Sun Dawu and millions like them who created the true China miracle.

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Preface

In 1998, during my field research in Shanghai for my last book, *Selling China*, I asked a government official whether he could introduce me to some private entrepreneurs. He gave me a quizzical look and asked, "Are you a Harvard professor?" (I was teaching at Harvard then.) "As a Harvard professor," he continued, "why are you interested in those people selling watermelons, tea, and rotten apples on the street?"

Somewhat taken aback by his response, I gently reminded him that companies such as Microsoft and Hewlett-Packard were all founded and run by private entrepreneurs. I then ventured to him that maybe the reason private entrepreneurs in Shanghai were just selling watermelons and tea is because these were the only activities the government allowed them to do.

The comment by that Shanghai official has always stayed with me, and it provided the initial inspiration to write this book. (One chapter in this book is entitled, "What is wrong with Shanghai?") It is striking how his comment contrasts with much of the theorizing about Chinese reforms in the West. A prevailing view among Western academics, especially economists, is that the goal of the Chinese state was to create a market economy based on private ownership, but the reforms were blocked by political obstacles. For political expediency, policy makers then settled for the second-best options to achieve the same goals – such as partially privatizing state-owned enterprises (SOEs), introducing foreign competition, and encouraging new entrepreneurship while retaining SOEs.

The truth is closer to the spirit of the comment by that Shanghai official. As late as 1998 much of the Chinese officialdom held private entrepreneurship in utter contempt. If it is indeed the case that the Chinese state *chose* to repress the private sector, there are some major puzzles. For one, how to explain the undisputed fact that the private sector actually managed to grow over time? I provided an explanation in my last book, *Selling China*, which shows that foreign direct investment (FDI), instead of bringing technology and knowhow, acted as venture capital or private equity by providing some financing to the repressed entrepreneurs. This is the reason why FDI is so prevalent in China, from high-tech to low-tech industries and from rich to poor regions of the country. Several empirical papers have systematically confirmed this hypothesis since the publication of my book.

FDI is not the end of the story. FDI flowed into China in the 1990s, and if FDI explained the growth of the private sector and economic growth in the 1990s, how does one explain the decade of the 1980s? The question of the 1980s exposed my own ignorance of recent Chinese history. I had always assumed, as do many other academics, that the Chinese reforms followed a gradualist trajectory – first beginning with modest, small steps and then accelerating the pace and the intensity of economic transformation over time. For many years, I held the view that the reforms in the 1990s were far more radical and far-reaching than the reforms in the 1980s.

A reader of this book would recognize that the thesis of this book is exactly the opposite. It shows that the true China miracle occurred in the 1980s and that it was a miracle created by the bottom-up entrepreneurship and considerable liberalization on many fronts. In the 1990s, there was in fact a substantial reversal of reforms.

I began to question my own assumption after I had an opportunity to discuss and debate with Dr. Zhang Wei. Zhang, now a lecturer of Chinese economy at Cambridge University, is extremely knowledgeable about the history of reforms. He was a rising star in the Chinese government in the 1980s, heading an important economic development zone in Tianjin at a young age. Zhang Wei, gently but firmly, told me that my gradualist perspective significantly understated the pace of reforms in the 1980s. Since that conversation, I began to notice that quite a few insiders – those who worked in the Chinese system – held a similar view. Li Changping, a rural official whom I quoted in Chapter 3, was most direct about the reversal of reforms in the 1990s.

But an academic treatment of this topic requires more than producing the opinions of insiders. The view has to be substantiated by data. This is the challenge. Few social scientists appreciate just how difficult it is to get accurate Chinese data, especially about the 1980s. The Cultural Revolution completely destroyed the Chinese system of data collection. According to one account, only 46 people worked at the National Bureau of Statistics (NBS) in 1976 and, as late as 1986, 90 percent of the Chinese economic data were handled manually. (In 1985, the NBS conducted an economic census. An American economist inquired about obtaining the raw data of the census, to which the reported response was that the magnetic tape containing the data fell into water and was completely damaged.)

At MIT, I often marvel at and envy some of my colleagues for their ability to generate data for their research – by designing elaborate experiments, sometimes using their students as objects. One of my colleagues designed an experiment in which he would take pictures of students in the dinning hall. (Maybe I would only marvel at them up to a point.) I do not have the similar luxury of generating data experimentally, and it is not easy to retrospectively survey people about their past, especially when the relevant people are former premiers or ministers (including quite a few who are still persona non grata, politically).

I settled on an alternative – researching government documents. China is not short on documents. One particular source of documents proved to be extremely useful to my project – collections of bank documents. For this book project, I examined thousands of pages of bank documents, many going back to the early 1980s. It is on the basis of the cumulative weight of the documentary evidence that I came to reject the gradualist interpretation of Chinese reforms.

A skeptical reader may argue that a conclusion based on documentary evidence is not rigorous enough. (Apart from the documentary evidence, I have also collected a substantial body of survey data.) In leveling this criticism, one should be reminded that the gradualist perspective was never systematically proven in the first place. The most convincing piece of evidence in support of the gradualist perspective is the rising output share by the private sector. In Chapter 1, I went into some detail explaining why this is a problematic indicator of policy evolution.

The question of methodological rigor is most relevant when we try to draw causal inferences, not when we attempt to establish facts. Here is one major difference between researching Chinese economy and researching American economy. In studies of American economy, scholars may debate about the effects of, say, "Reagan tax cuts." In studies of the Chinese economy, the more relevant question would be, Did the government cut taxes in the first place? Much of this book is about documenting facts, including establishing an accurate definition of township and village enterprises (TVEs) and coming up with an analytically appropriate measure of policy evolution toward the private sector.

Two individuals should be singled out for being most helpful in my effort to source documentary evidence on Chinese reforms. One is Jean Hung, who was the librarian at the University Service Centre at the Chinese University of Hong Kong. Jean created an amazing collection of documents on China. One book that I used at her library shows the reach and the depth of her collection: Only 24 copies of that book were ever printed. Her collection goes way back – to the late 1970s and the early 1980s – and was meticulously catalogued. I owe her a huge debt of gratitude.

Nancy Hearst, at Harvard's Fairbank Center Library, was equally instrumental to my project. Her library, unquestionably, is the best place to do research on contemporary China outside of Asia. Nancy has also helped this book project in other ways. She edited and proofread the earlier versions and corrected many of the mistakes I made. I am very grateful to her.

Over the years, I have had a number of capable research assistants. These include Lu Gao, Yu Lu, Heiwai Tang, Yanbo Wang, and Wendi Zhang. Others tracked down and provided crucial data. Professor Yifan Zhang at Lingnan University in Hong Kong generously shared data with me, and Yang Zhi at Hong Kong University assisted me in data analysis. Scott Parris, my editor at Cambridge University Press, and Ken Karpinski, my project manager at Aptara, provided the most efficient assistance in the production process of this book. I am deeply grateful to them.

Let me also thank those individuals and colleagues with whom I have discussed the ideas in the book and those who have provided valuable comments on earlier drafts or presentations of ideas. These include William Baomul, Pranab Bardhan, Suzanne Berger, Kristin Forbes, Jun Fu, Simon Johnson, Devesh Kapur, Tarun Khanna, Nicholas Lardy, Don Lessard, David Li, Rick Locke, Minxin Pei, Guy Pfeffermann, Ed Steinfeld, Lester Thurow, Laura Tyson, Ashutosh Varshney, Eleanor Westney, and Alan White. Four anonymous reviewers at Cambridge University Press provided very helpful comments.

This book would not have been written without the unfailing support and encouragement from my wife, Jean Yang. She endured many of my absences from home while she was taking care of our two young daughters, Kunkun and Nanan, and working as a high-level executive at a health insurance company. She was my first testing ground of the sanity of many of my ideas. My daughters may have improved my work as well, if indirectly, when they took away my laptop and wrote or painted their own expressions over my writings.

Finally, I devote this book to three individuals who, I believe, represent the true China miracle. I referred to them in different parts of the book – Nian Guangjiu in Chapter 2 and Zheng Lefang and Sun Dawu in Chapter 3. All three were rural entrepreneurs, and they met the common unhappy fate of being brought down by the illiberal policies of the 1990s. In my modest way, I am noting their contributions here.

– Yasheng Huang on June 6, 2008, in Delhi, India.

A Detailed Synopsis of the Book

Since 1978, the Chinese economy has grown phenomenally. This is not in dispute. By exactly what mechanisms has China managed to grow so fast? There is more room for debate on this question. The near-consensus view – or the view that has achieved the greatest traction – among economists is that China has grown by relying on unique, context-specific local institutional innovations, such as ownership by the local state of township and village enterprises (TVEs), decentralization, and selective financial controls. The conventional mechanisms of growth, such as private ownership, property rights security, financial liberalization and reforms of political institutions, are not central components of China's growth story.

Much of the economic research on the Chinese reforms revolves around the following question: Given the manifest inefficiencies in the Chinese economy, how do we explain its growth? The answer, often backed up by formal, mathematical models, is that seemingly inefficient policies, practices, and institutions – such as public ownership of TVEs and financial controls – perform underlying efficient *functions* in the specific context of China. The approach is typically inferential – these efficient functions of observably inefficient forms are inferred from China's excellent economic performance.

This book takes a different and factual approach. It starts with the following set of questions: Were TVEs really publicly-owned? Did China implement financial reforms prior to or concurrently with the initial economic takeoff in the early 1980s? The research is based on detailed archival examinations of policy, bureaucratic, and bank documents as well as several waves of household and private-sector firm surveys. The qualitative and quantitative data span the period from 1979 to 2006. This book is factually dense – I have examined thousands of pages of memoranda, directives, operating manuals, and rules of personnel evaluations issued by the presidents of

China's central bank, all the major commercial banks, rural credit cooperatives, and so on. These documents are contained in a 22-volume compilation of bank documents, which, while available at Harvard and in Hong Kong, have never been examined by a Western academic. I have also gone to the raw database on TVEs established by the Ministry of Agriculture. The Ministry of Agriculture was in charge of collecting data on TVEs, and its data have finer ownership breakdowns than the TVE data available in *China Statistical Yearbooks*. Based on this body of research, here are the main findings:

- *Explicitly* private entrepreneurship in the non-farm sectors developed vigorously and rapidly in rural China during the 1980s.
- Financial reforms, again in the rural areas, were substantial in the 1980s, and the Chinese banking system channeled a surprisingly high level of credits to the private sector in the 1980s.
- Conventional property rights security was – and still is – problematic, but the security of the proprietor – the person holding the property – increased substantially at the very onset of the economic reforms.
- The Chinese policy makers in the early 1980s strongly, directly, and self-consciously projected policy credibility and predictability.
- The political system, although absent of the normal institutional constraints associated with good governance, became *directionally liberal* early during the reform era.

This book clarifies the following perspectives/issues and provides new information and illustrative data:

- The Chinese definition of TVEs refers to their *locations* of establishments and registration (i.e., businesses located in the rural areas), not their ownership; Western researchers, on the other hand, have come to understand TVEs in terms of their *ownership* status.
- The cognitive gap is huge: As early as 1985, of the 12 million businesses classified as TVEs, 10 million were *completely* and *manifestly* private.
- Almost every single *net* entrant in the TVE sector between the mid-1980s and the mid-1990s was a private TVE; thus both the static and dynamic TVE phenomena were substantially private.
- Private TVEs were most vibrant in the poorest and the most agricultural provinces of China (and this feature of private TVEs also explains the understatement of their size in the conventional reporting as well as the connections between rural private entrepreneurship and poverty alleviation).

- There are reports of privatization of collective TVEs in the early 1980s and large-scale privatizations in the poor provinces.
- Rural financial reforms – credit provisions to the private sector and allowing a degree of private entry into financial services – in the 1980s were endorsed by the governor of the central bank and the presidents of the major commercial banks.
- Chinese reforms were heavily experimental in nature rather than relying on a blueprint approach, but the outcome of the experimentation was private ownership and financial liberalization.

A good explanation for the Chinese growth experience should be able to account for its well-known successes as well as its equally well-known failings (such as a weak financial sector, rising income disparities, constraints on private-sector development, etc.). The key to our understanding of the China story is that China reversed many of its highly productive rural experiments and policies beginning in the early 1990s. In the 1990s, Chinese policy makers favored the cities in terms of investment and credit allocations and taxed the rural sector heavily in order to finance the state-led urban boom. The policy changes in the 1990s were not experimental; rather they were rooted in a technocratic industrial policy blueprint and a heavy urban bias. This book shows:

- By the measure of private-sector fixed-asset investments, the most liberal policy epoch, by far, was in the 1980s; in the 1990s, the policy was reversed, and many of the productive rural financial experiments were discontinued.
- Rural administrative management was substantially centralized in the 1990s.
- Credit constraints on rural entrepreneurship, including private TVEs, rose substantially in the 1990s.
- Growth of rural household income in the 1990s was less than half of its growth in the 1980s, and the declining growth in the rural business income was especially pronounced.
- The size of government – measured in terms of headcounts of officials and the value of fixed assets it controls – expanded enormously in the 1990s.
- The directionally liberal political reforms of the 1980s were discontinued and reversed.

This book devotes an entire chapter to Shanghai, for two reasons. One is that Shanghai represents the classic urban-bias model – the city restricted the development of small-scale, entrepreneurial, and typically rural businesses while conferring tax benefits on foreign direct investment (FDI) and on businesses closely allied with the government. The other is that at the end of the 1980s Shanghai was among the least reformed of the urban economies in China, and yet its leaders during the second half of the 1980s went on to dominate Chinese politics during the entire decade of the 1990s. This book asks, What is wrong with Shanghai? and proceeds to present the following illustrations:

- Although they are located in the richest market in China, indigenous private-sector businesses in Shanghai are among the smallest in the country, and self-employment business income per capita is about the same in Shanghai as it is in provinces such as Yunnan, where GDP per capita is about 10 to 15 percent of that in Shanghai. (As an illustration of how unusual the above pattern is, imagine finding that self-employment business income per capita in the United States was about the same as that in Turkey.)
- The political, regulatory, and financial restrictions on indigenous private entrepreneurship in Shanghai were extreme, as evidenced by the fact that the fixed asset investments by the indigenous private-sector firms peaked in *1985*.
- The share of labor income – inclusive of proprietor income – to GDP is very low in Shanghai.
- Shanghai's GDP increased massively relative to the national mean, but the household income level relative to the national mean experienced almost no growth.
- Although wage income is high in Shanghai, asset income is among the lowest in the country.
- Since 2000, the poorest segment of Shanghai's population has lost income *absolutely* during a period of double-digit economic growth.
- Although aspiring to be a high-tech hub of China, the number of annual patent grants in Shanghai decreased substantially relative to that in the more entrepreneurial provinces, such as Zhejiang and Guangdong, in the 1990s.
- Shanghai was also corrupt.

Capitalism with Chinese characteristics is a function of a political balance between two Chinas – the entrepreneurial, market-driven rural China vis-à-vis the state-led urban China. In the 1980s, rural China gained the upper hand, but, in the 1990s, urban China gained the upper hand.

Although China made notable progress in the 1990s in terms of FDI liberalization and reforms of state-owned enterprises (SOEs), this book assigns greater weight to the rural developments in determining the overall character and the pace of China's transition to capitalism. When and where rural China has the upper hand, Chinese capitalism is entrepreneurial, politically independent, and vibrantly competitive in its conduct and virtuous in its effects. When and where urban China has the upper hand, Chinese capitalism tends toward political dependency on the state and is corrupt.

Most economists judge China's economic performance by its GDP data. While decadal differences in China's GDP growth are fairly small, the economic and social implications of a more entrepreneurial version of capitalism in the 1980s and the one closer to state-led capitalism in the 1990s in fact differed enormously. There are substantial and real welfare consequences:

- Although GDP growth was rapid during both the 1980s and 1990s, household income growth was much faster in the 1980s.
- The share of labor income to GDP was rising in the 1980s but declining in the 1990s.
- Several studies on total factor productivity (TFP) converged on the finding that TFP growth since the late 1990s has either slowed down from the earlier period or has completely collapsed.
- The majority of the much-touted poverty reduction occurred during the short 8 years of the entrepreneurial era (1980–1988) rather than during the long 13 years of the state-led era (1989–2002).
- Income disparities worsened substantially in the 1990s, while they initially improved in the 1980s.
- Governance problems, such as land grabs and corruption, intensified greatly in the 1990s.
- The heavy taxation on the rural areas led to the withdrawal and rising costs of basic government services.
- Between 2000 and 2005 the number of illiterate Chinese adults increased by 30 million, reversing decades of trend developments; this development has garnered almost no attention in the West.
- The way the Chinese measure adult illiteracy implies that all of this increase was a product of the rural basic education in the 1990s, and this adverse development coincided closely in timing with the intensification of urban bias in the policy model.

Capitalism with Chinese Characteristics constructs a direct, factual observation of China's economic and institutional processes, practices, and policies. Formal modeling and systematic empirical research are important tools to resolve academic and policy debates, but they can do so only with the right set of facts at hand. This book sets out to get the facts right.