China and the Legacy of Post-Mao Reforms

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China and the Middle Income Trap: the Legacy of Post-Mao Reforms

China's growth in the reform era has been phenomenal: GDP quadrupled in China between 1986 and 2010 (World Bank; 2011[a]). They have been successful in achieving human development also. In 1980 China fell over 15 percentage points below the world average in the Human Development Index but by 2010 they had risen to 0.5 percentage points above it (United Nations Development Program; 2011). The World Bank notes that much of the discussion surrounding China's policy-making now focuses on how best to avoid the "middle-income trap" (World Bank; 2011[b]), where (in Ohno's model) economies are unable to move from the second stage of development, where domestic industries support foreign investment-led development, to the third stage of absorbing foreign technologies and focusing on high quality goods production (Ohno; 2009, pp.26-28). I will argue that development policies enacted in China in the post-Mao reform era have left the Chinese government unable to fund a long-term development plan to assist the transition from stage two to stage three of Ohno's model and as such, are unsustainable. Further, these policies have left China's private sector unable (or unwilling) to invest in absorptive capabilities. This is again damaging: Ohno stresses that ultimately, 'the private sector…should be the agent of production and investment' (Ohno; 2009, p.32).

The flaws in China's development policies stem from the Chinese government's commitment to maintaining political stability (Xia; 2000, pp.69-72). The key problem is that this subjects policy makers to political demands beyond their proper remit. In his description of Brazil and Mexico, Schneider notes that the development efforts of those countries are undermined by the fact that members of the bureaucracy must ally themselves to the political elites in order to maintain their positions. As such, policies are often designed to serve the elites rather than the country as a whole (Schneider; 1999, pp.291-293). A similar situation can be seen in China. CPC leaders tend to choose policies that will avoid causing disagreement amongst the political elites, and as such the best policies are sacrificed to acceptable compromises (Breslin; 1996, pp.290-295). Qian supports these policies, arguing that reforms in China were designed, 'to improve efficiency while remaining compatible with the interests of those in power' (Qian; 2003, p.305). I will argue that the same interests constrain China's development. The first aspect of the constraints I will examine is China's treatment of her state-owned enterprises (herein SOEs).

SOEs play a significant role in China's economy; in 1995 they employed around 65% of the workforce, accounted for 71% of the government's revenue and absorbed over 75% of domestic credit (Steinfield; 1998, pp.16-21). In spite of this, the sector is close to insolvency. In 1996 more than half of China's SOEs officially declared losses, and estimates of bad debt held by the state-owned sector at that time range from RMB 860 billion to nearly 1.3 trillion (Steinfield; 1998, pp.20-21). Despite employing 65% of China's workforce, SOEs accounted for less than 35% of national industrial output in 1995 (Steinfield; 1998, p.13). Why, then, are China's leaders so insistent on extending credit to the sector?

In contemporary China, 'the fear of instability runs deep' (Stiglitz; 2002, p.184), and with the famines of the Great Leap Forward still ingrained in China's leaders' memories, the fear of mass unemployment and social upheaval that may accompany the collapse of the state-owned sector is, perhaps, sufficient to cause them to continue to subsidise failing and inefficient firms (Steinfield; 1998, p.60). There are two key problems with this treatment of SOEs, both undermining long-term investment. The first is that since there is no real threat of bankruptcy SOEs are not motivated to streamline their operations and become more profitable (Steinfield; 1998, p.19). The losses of the sector then limit available government revenue for the reforms China now needs. The second problem is that SOEs absorb domestic credit that could otherwise be extended to profitable private sector firms. This problem is exacerbated by SOEs' failure to use credit to fund long-term investments. To take one example, in 1995, Anshan Iron and Steel, a major SOE, increased its debts by nearly RMB 72 billion, yet only 0.4% of this was used to fund long term investment projects (Steinfield; 1998, p. 85). The remainder was used as a subsidy for operational losses. Evans notes that subsidies are not implicitly undesirable, but they are to be used to help infant industries establish themselves against foreign competition (Evans; 1995, p.80). If the subsidies are not met with increases in efficiency, they must be withdrawn (Evans; 1998, p.67). That is clearly not the case here; subsidies are being used to cover inefficiencies.

Another effect of the politically constrained bureaucracy is a volatile economic environment. One of the characteristics of Chinese reforms has been that policies attempt to ensure that no one region or part of the political elite loses out, and where policies cause even relatively minor problems, officials are quick to retract the offending policy (Breslin; 1996, pp.690-695). This means that private sector firms are unable to plan long term investments as they do not know if policies that affect their position will be introduced, modified or removed and on what time-scale. Whilst this is an effort to ensure that reform 'creates only winners, no losers', (Qian; 2003, p.308) economic stability is compromised. This effect is compounded by the decentralisation of financial autonomy in the reform era. Breslin argues the problem of decentralisation is that it prevents a coherent, unified development policy of the type found in South Korea or Taiwan (Breslin; 1996, pp.698-701). I disagree. China's size and geographic and economic heterogeneity puts it beyond the confines of the traditional developmental state model, in which the relationship between the centre and the provinces – if it exists at all – is not significant (Xia; 2000, p.30).

Rather, the problem is that the decentralisation of financial autonomy has not been accompanied by a decentralisation of accountability (Steinfield; 1998, p.61). Decentralisation is not a new concept in China: Mao himself advocated it as a way to avoid the high costs of full centralisation while maintaining central control (Riskin; 1987, pp.102-104), imposing central objectives on provinces that can then be adapted to suit local circumstances (Riskin; 1987, pp.83-84) and this is something China still requires. However, it is not uncommon for provincial authorities to implement selectively central policies as and when they yield benefits to themselves (White; 1996, pp.152-155) (Wank; 1999, p.188). These combined effects of erratic policy making and selective regional implementation create an uncertain economic environment for firms in the private sector which does not lend itself to support long-term investments (Evans; 1998, p.67). These factors do, however, lend themselves to corruption. This process occurs in two ways.

First, the absence of accountability in local authorities allows for predation with relative impunity. Officials are able to extract funds from private-sector firms in their role as agents of the state, and from public-sector enterprises as owners (Steinfield; 1998, p.62). Certain reform policies have not helped this problem: whilst Qian supports the policy of anonymous bank deposits, suggesting that it prevents state officials from preying on wealthy and successful individuals (Qian; 2003, pp.318-322), the same policy allowed corrupt officials to conceal their private wealth and avoid punishment. Qian herself admits that the rule of law would be a more efficient way to avoid predation (Qian; 2003, p.318). One problem faced by private sector firms is that there is no higher power to which they can appeal; those extracting funds from them are agents of the state, and property rights are still virtually non-existent (Steinfield; 1998, p.62). The problem is only made worse by the increasing number and complexity of governmental bodies; as Steinfield puts it, 'There is a great deal of government, very little law, and even less subjection of the former to the latter' (Steinfield; 1998, p.62). Transparency International's Corruptions Perceptions Index supports this, rating China 3.5 out of 10 (10 being the least corrupt), a score it has maintained for over a decade (Transparency International; 2011) (Transparency International & Göttingen University; 1998).

The second effect is more contentious. Wank argues that utilising the *guanxi* system of personal ties is actually more efficient than trying to eliminate it. His argument is that although securing contacts with authorities is costly (bribes are usually required), without them, it would be far more difficult to gain access to resources (Wank; 1999, p.170). Wank has failed to distinguish between what is efficient for any particular entrepreneur and what benefits the economy as a whole. Whilst it is true that benefits are usually given to those firms that are profitable enough to afford to pay bribes (Wank; 1999, p.36), once these networks are in place they act as barriers to entry, and the incumbent firms have fewer incentives to invest to stay competitive.

With potential tax revenue siphoned off into the anonymous bank accounts of corrupt officials, provinces are left searching for other ways to meet their revenue targets. At the same time, private sector firms look for funds as domestic credit is focused on SOEs. One way the state and private sector alike have sought to solve these problems is through attracting foreign direct investment (FDI), in the hope that foreign technology will be absorbed by domestic businesses (Wei; 2004, pp.26-28). China's experimentation with FDI began with the creation of special economic zones (SEZs) in 1980, offering favourable tax conditions and profit repatriation, amongst other things, to attract investors (Riskin; 1987, p.325).

Whilst opening up to foreign investment has been linked to poverty reduction (Dollar & Kraay; 2003, p.448) it introduces associated problems. Firstly, profit repatriation extracts money from the economy and sends it abroad, although this factor may, in part, be mitigated by the "round-tripping" effect (Xiao; 2004, p.2). Secondly, foreign investment tends to crowd out domestic investment and discourage entrepreneurship (Stiglitz; 2002, p.68). Finally, moving beyond the middle-income trap requires absorption of technologies for higher value-added goods production. However evidence suggests spill-overs are only occurring with low and medium technologies (Wei; 2004, pp. 26-28). From 1995-98, manufacturing attracted 66% of FDI, whilst the high-technology sectors of scientific research and technical services attracted less than 0.3% (Wei; 2004, p.15). At the same time, wholly-owned foreign enterprises are accounting for an increasingly large share of FDI, as investors fear 'the loss of control over proprietary technology and know-how' (Wei; 2004, p.13).

It is precisely this technology that China requires if domestic industries are to develop. Wei argues that if China is to encourage spill-overs from FDI in higher value-added sectors, 'China and her regions need to upgrade the industrial structure and physical, financial and technological infrastructures' (Wei; 2004, p.23). Upgrades require investment from both the state and the private sector, and for the reasons I have laid out above, it is difficult to see how this investment will be paid for. Qian argues that often too much emphasis is put on the role of FDI in China (Qian; 2003, p.299), and at its peak in 1995 FDI accounted for a modest 13.4% of GDP (UNCTAD; 2011). However, 50% of this went to three regions alone (Guangdong, Fujian and Jiangsu) and the local economies in these regions are relatively dependent on FDI. As other regions look to emulate the success of the SEZs (Xia; 2000, p.59) FDI may play an increasingly important and unsustainable role.

In summary, the CPC's desire to maintain political stability has at each level constrained the long-term infrastructural and technological investments that China needs if she is to advance beyond the middle-income trap. Whilst low labour costs will continue to attract FDI in the short-term, China may lose her competitive edge as neighbouring countries adopt policies to attract FDI (Wei; 2004, p.23). China may then find herself without the revenue required to develop further. At the beginning of the reform era China was, 'deep within the production possibility set' (Qian; 2003, p.305). Whilst the development policies in the reform era have been successful in returning China to the edge of her production possibility set, serious reforms will be needed to expand the set itself.

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