

# **China's Growth Strategies \***

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## 1. Introduction

The household responsibility system (HRS), dual-track pricing, township and village enterprises (TVEs), special economic zones (SEZs), are all household names amongst development specialists. The two common characteristics of all these reforms are that they took place in post-reform China, and that they were innovative “hybrid” solutions to both the economic and political problems facing Chinese policymakers. Since the late 1970s these reforms have helped China achieve rapid economic growth and lift hundreds of millions of its people out of poverty. These achievements have been generally surprised most observers, including economists, because many of China’s development strategies seem to be unorthodox and in defiance of conventional theories of growth and development.

The miraculous growth rate of China’s economy has prompted a great deal of study, especially among economists. One strand of the economic literature decomposes China’s economic growth into labor, capital, and technology and/or institutional change components. Most of these quantitative studies (Lin, 1992; Fan, Zhang, Zhang, 2004) find that institutional change accounts for a significant proportion of the observed economic growth since the reform. In addition, the structural change from low-productivity agriculture to more productive industrial and service sectors also contributed to rapid economic growth. While this body of literature undoubtedly helps increase the understanding of the major sources of China’s growth, it does not address the question of how the institutional changes occurred in the first place.

There is another large body of literature, including many chapters in this volume, examining particular reform measures to justify their logic from an *ex post* point of view. From hindsight, many of the reform measures make good economic sense and fit well into the political economy and governance context. But for any given reforms, there are always alternative paths. It is not clear from the academic literature how the seemingly heterodox strategies arose in the first place. In this volume, in addition to having papers from leading scholars, we also include papers from key policy advisors who were actively involved in the reform process and have played an instrumental role in some of the key reforms. Their insider’s view on the internal process of reforms is complementary to the writings of academic “outsiders”.

In this opening chapter, we will first review the major views on China’s development and reform strategies. Then we discuss why the same forces behind China’s rapid growth also create new

challenges. In the last section, we make some remarks on the Chinese experience and lessons, and their transferability to other countries.

## **2. A Review of China's development strategies**

There are numerous studies on this topic. Jefferson (2008) provides an excellent review on China's reform experience and on how the economics literature has tried to explain that experience. One key difference of our chapter is that we try to combine both the insider's and the outsider's views on the reform process. However, in doing so, we constrain ourselves to the major strands of the existing literature rather than trying to provide a comprehensive review.

### Realigning the economy towards China's comparative advantage

Lin, Cai, and Li (1996, Chapter 13 in this volume) and Lin (2007) argue that China's rapid growth since the reform is mainly due to the rebalancing of China's development strategy away from a central focus on heavy-industry and in the direction of more labor-intensive sectors. When the People's Republic of China was just established, China lacked capital and faced international isolation. Influenced by the experience and ideology of the Soviet Union, China placed the development of heavy industry as the top priority if it was to catch up with the developed nations as soon as possible. To achieve this goal, the government suppressed the procurement price for grains, restricted rural migration, and set up some barriers between rural and urban residents. Since this strategy was capital intensive, it violated China's comparative advantage, which was defined by limited capital and abundant labor, and led to nearly three decades of stagnation in per capita income.

Since the economic reforms beginning in the late 1970s, the central government has shifted its development strategies toward more labor intensive sectors, initially agriculture, and then increasingly export-oriented rural industries. In the global context, China possesses an obvious comparative advantage in the labor-intensive manufacturing sector. After introducing the open door policy, massive foreign direct investment flowed in and married with China's cheap labor. As a result, both capital and labor resources were more efficiently allocated, which greatly boosted economic efficiency. China's development path therefore reemphasizes the importance of adhering to comparative advantage in creating labor-intensive, export-oriented economic growth (Krueger 1978, Krueger 1983, Krueger 1984, Little et al. 1970). A variation of this theme is that realignment towards comparative advantage may be necessary for accelerated growth, but is not by itself sufficient. Ravallion and Chen (Chapter 5, this

volume) argue that China's post-1978 economy also benefited from many of the social and infrastructural investments of the pre-1978 period, especially with regard to education, health and transport infrastructure. Thus they invoke a fairly standard notion of conditional convergence to explain China's post-1978 catch-up.

However, there are perhaps two problems with the comparative advantage explanation of China's success. Firstly, comparative advantage is nearly always identified *ex post*, or after the event (Wade 1990). Prior to implementing reforms it may not be so obvious what products a country will have some specific comparative advantage in. Discovering specific comparative advantages may not be achieved under a *laissez-faire* system because the process of discovering comparatively advantageous activities entails risks and uncertainties, and because the entrepreneurs that carry out these search and discover activities rarely capture all of the rewards to their success (Hausman and Rodrik 2003). Existing research on other East Asia miracles has also argued that the secret of their success was investing in the growth of future areas of comparative advantage (Amsden 1989, Wade 1990). Secondly, this theory does not explain the process of successful transition in China. Since the late 1970s policymakers in many other developing countries in Africa and Latin America have attempted to shift their economies away from capital-intensive sectors towards more labor-intensive activities, but many of these countries have experienced sluggish growth at best, stagnation at worst. How did China manage its own process of reform so successfully? We will come to this point when reviewing China's reform process as recounted in this volume by key Chinese policy advisors (Chen, Chapter 3; Lou, Chapter 3; Du, Chapter 4).

### Incentives matter

It is sometimes argued that the first and most important principle of economics is that incentives matter (Easterly 2002). A large body of literature has documented that during the planning era China's rural communes or collectives were dogged by weak incentives due to free rider problems, especially in agricultural production (Lin, 1990). Farmers did not want to work hard because the fruits of their toil were shared among others, rather than just themselves. Likewise, in the state-owned enterprises (SOEs), shirking was also reported to be a widespread problem (Xu, 2003), and many SOEs made significant losses. A major theme of market-oriented reform studies on China is that the post-1978 government gave strong incentives for individuals - including farmers, managers and local officials - to increase investment and improve productivity. Several major reforms all have the spirit of empowering

ordinary people or local governments to make their own economic choices and reap the rewards of those choices.

Take the Household Responsibility System (HRS) – one of the earliest reforms - as an example. The principle of the HRS is that individual households can claim the residual of their own production after fulfilling the grain quota to both the state and collective units. Because peasants could possess all remnants after fulfilling the state quota, their interest in increasing production dramatically increased. The improved incentive system also had the effect of immediately resulting in a much fuller utilization of long-term investments made by the State in agricultural research and development, irrigation, and other infrastructure. In the space of just several years', agricultural productivity nearly doubled (Fan, 1991; Lin, 1992). And as shown by Ravallion and Chen (2007, chapter 5 in this volume), it was rural reform that triggered China's economic growth and alleviated a record number of people from poverty in just several years.

Subsequent SOE reforms followed in the same spirit. Initially, a manager-responsibility-system was introduced to give the SOE managers more discretionary power in making decisions and offering them performance-based pay packages. However, because SOEs had to take care of employees that were not covered by social welfare by providing their own housing, healthcare and pension, SOEs still found it hard to compete with the lower cost town-village and private enterprises. By the middle and late 1990s, most small and medium SOEs were privatized or experiencing large numbers of layoffs.

A variant of the "incentives matter" explanation of China's growth focuses on decentralization within China's government. Most of the literature has paid particular attention to fiscal decentralization as a major drive of China's economic growth (Jin, Qian, and Weingast, 2005, Chapter 14; Cheung, 2008). During central planning, local governments had to turn in most of their local revenues to the central government, and there was no clear rule as to how central finances were to be devolved to lower governments. Since the 1980s China has adopted a series of fiscal reforms aimed at improving the fiscal contract arrangements between different levels of governments. After fiscal reforms, local and upper level governments shared fiscal revenues according to a predetermined formula. Since local governments can keep a significant portion of the increased local revenues, they face stronger incentives to increase local revenue (note the analogy to the HRS).

Of course, fiscal decentralization need not result in faster growth unless local governments have incentives to use increased finances productively, yet governance reforms in China did indeed complement fiscal decentralization with improved incentives. Modern China has always had centralized merit-based governance structure. In the planning economy era, the evaluation of cadres was largely based on political performance. However, since the China's reforms initiated in 1978, political conformity gave way to economic performance and other competence-related indicators as the new criteria for promotion. The promotion of China cadres' is now largely based on yardstick competition in several key economic indicators, including economic and fiscal revenue growth rates, and some central mandates, such as family planning (Li and Zhou, 2005, Chapter 12, this volume). These indicators have been written into local leaders' contracts. This creates tremendous pressure for local government personnel to compete with each other through superior regional performance. Consider the fact that China has over 2,000 counties and that because capital is largely mobile these counties have to compete for capital in a pro-business environment wherein investors are trying to maximize returns (Cheung, 2008). Strong incentives for local governments to achieve rapid economic growth helps explain why China has grown so quickly despite a lack of well defined property rights protection in the *de factor* legal system (Zhang, 2007): competition serves as the disciplinary mechanism by which local governments provide *de jure* protection of investors' property rights. Of course, the existence of strong growth-oriented incentives also explains why the protection of the property rights of other groups, such as farmers, has been weak (Zhang 2006a).

To summarize, the Chinese central government has used both fiscal incentives and personnel policies to ensure that local governments use their financial empowerment to increased economic growth. Although there is not much systematic international evidence on the importance of decentralization for economic growth, a research program on Decentralization, Fiscal Systems and Rural Development in the mid 1990s across 19 countries (or provinces thereof) found that Jianxi province in China easily had the highest degree of decentralization (McClean et al. 1998). Other studies have also pointed out that making decentralization and local empowerment schemes work requires the fulfillment of a large number of conditions in addition to fiscal decentralization (Mansuri and Rao 2004, Prud'homme 1995). China has benefited from a number of favorable conditions – ethnic homogeneity, land equality, strong central governance – but China's experience also reiterates the importance of good incentives for local governments, even if the mechanism by which governors are disciplined is not the electorate. So although the principle of incentives is rather universal, the exact forms used to improve incentives in

China may not be easily transferable. Moreover, fiscal decentralization can come at a cost, especially insofar as it increases spatial inequality (Kanbur and Zhang 2005, Chapter 6 in this volume; Zhang 2006b).

#### Experimentation and marginal reform as a solution to risk, uncertainty and opposition

As argued above, good reforms can be very difficult to identify *ex ante*. But even if a good reform measure has been identified, reformers still need a reform strategy capable of overcoming or circumventing political resistance to reform. Indeed, the political challenge of reform can be at least as difficult as the intellectual challenge of identifying the economic direction of reform. Traditional economic models of development generally do not address the political viability of reform (Ahrens 2002). The public choice school – which attempted to apply economic choice-theoretical models to the political arena – seeks to explain policy decisions in terms of individual incentives and the outcomes of deliberations between political groups e.g. factions, lobbies, political parties (Rodrik 1996). But such models are generally dissatisfactory in this context because they assume that good policies are known *ex ante* – an assumption we have already questioned - and that the “preferences” (ideologies, beliefs, normative objectives) of individuals and groups are exogenous. This second assumption is also insufficient because as the chapters in this volume by the reform “insiders” demonstrate, successful political reform often requires persuasion, or, more explicitly, changing people’s preferences, ideologies, beliefs and normative objectives.

In that vein, institutional and behavioral economics generally offers a more flexible framework for thinking about the process of reform. According to Denzau and North’s (1994) notions of shared mental models, in situations of uncertainty– such as China in 1978 - people act in part upon the basis of myths, dogmas, ideologies and "half-baked" theories. Moreover, the psychological notion of cognitive dissonance suggests that people do not easily disassociate themselves from their existing mental models, especially without overwhelming evidence to violate the incumbent model.<sup>1</sup> China’s insulated,

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<sup>1</sup> In psychology, cognitive dissonance is defined as an uncomfortable feeling or stress caused by holding two contradictory ideas simultaneously (e.g. such as “socialism works” and “markets work”). The theory of cognitive dissonance proposes that people have a fundamental cognitive drive to reduce this dissonance by modifying an existing belief, or by rejecting one of the contradictory ideas. From this viewpoint many of Deng’s statements can be seen as means of diffusing cognitive dissonance. For example, Deng Xiaoping emphasized that:

"Planning and market forces are not the essential difference between socialism and capitalism. A planned economy is not the definition of socialism, because there is planning under capitalism; the market

ideology-driven, single-party pre-1978 society meant that the orthodox shared mental model of China's leaders and its people – founded on Maoist and Socialist principles - was a significant barrier to market-oriented reform. Changing this model was therefore both an important precondition of successful reform, and a result of reform. A key insight, then, from the “insider” chapters of this volume is that China's elites chose reform strategies that involved minimized political opposition to reform.

In the political arena, Deng and other market-oriented reformers made use of two strategies aimed at changing the shared mental model of the nation. Influencing the mindset of China's ruling elite was the first obstacle. Deng Xiaoping was relatively unique in that he had lived a substantial period of time in a Western country (France) and had seen the benefits as well as the costs of capitalism, an experience which evidently made his own attitudes relatively pragmatic. In order to change the mindset of other leaders he encouraged them to take education tours overseas, and persuade Singapore's leader, Lee Kuan Yew, to visit China and speak on the issue of reform. Down the line, however, it was also important to address the mindset of the greater population, which had long been taught to venerate Maoist Socialism. China's control of the State media, of education, and its tradition of hierarchical governance, meant that the Chinese leadership could very effectively publicize the direction of reform in China. Famous public announcements such as “the Four Modernizations”, “socialism with Chinese characteristics”, and “seeking truth from facts” all helped the shift people's mindsets, and signal to the broader economy that China was heading in a new direction. Whilst economists largely ignore such hyperbole, the political economy literature regularly emphasizes the importance of credible reform, and more recent research has also emphasized the importance of soft institutional change (in the case of India, for example, see Rodrik and Subramanian (2004)).

In the economic arena, Chinese reformers used two related strategies to simultaneously promote economic learning and overcome political resistance to reform: (1) *reforms at the margin* (e.g. dual track pricing in agriculture and housing); and (2) *more explicit experimentation*.<sup>2</sup> The economic role of these policies is self-discovery in the face of uncertainty. To quote the oft-cited phrase from Ding Xiaoping, the

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economy happens under socialism, too. Planning and market forces are both ways of controlling economic activity.”

<sup>2</sup> We note that although marginal reforms have some features of experimentation (like experiments, they may be more reversible than wholesale reform, and they also promote learning), but they also have some distinguishing features relative to other experimental reforms.

supreme leader in the early reform period, China's reform has been "crossing the river by feeling the stones." The political role is more pragmatic, as noted in the "insider" chapters in this volume, which emphasize the important role that experimentation in overcoming political resistance to reform. However, some economist "outsiders" have also emphasized this role.

*(1) Reforms at the margin*

Studies on the dual-track price reform (Lau, Qian, and Roland, 2000) are a noted example. Prior to reform, in the hierarchical property right and entitlement system, urban sectors and particularly state-owned enterprises (SOEs) came under the control of the central, provincial, and municipal governments and thereby enjoyed privileged access to a variety of scarce materials and capital goods through quotas. There were few quotas, however, for other lower-level state-owned enterprises and even fewer for collectively-owned enterprises. The dual pricing system allowed state-owned enterprises to sell unused input quota at market prices to township and village enterprises (TVEs) that were outside the command economy. Such exchanges not only protected the original privileges of higher ranking entitlements, but also presented TVEs with opportunities to access industrial inputs via market channels and to participate in the market economy. In other words, the dual pricing system provided a functional pricing mechanism for rent-sharing through both hierarchical and market systems. Because the dual-price reform initially did not have a negative impact on the SOEs' entitled planned quota, their resistance was muted. Over time, as the private sector grew rapidly and the market price and planned price converged, the dual-track was eventually unified into a single track, or market price.

The urban housing reform makes use of the same compensation principle. In the socialist period, *Danwei* (SOEs or government units) were responsible for providing housing to urban residents. Along with economic reform, SOEs were compelled to be more profit driven. Therefore the provision of public housing was slowed down and could not keep up with increasing demand. This forced the government to undertake urban housing reform in the 1990s. The housing reform packages treated the insiders and outsiders differently. Those already living in public housing were allowed to buy their occupied apartments at a discount price. However, employees buying new houses were made to pay market prices with employers contributing some matching funds to a special housing account so as to ease the burden of purchase. Under this policy, the housing market was privatized quickly without causing much resentment. More importantly, the emergence of a semi-private real estate market sent powerful signals to consumers and producers. Since the urban housing reform, China's construction sector has

boomed. In just fifteen years, per capita living space in cities has jumped from 8.8 square meters in 1986 to 15.5 square meters in 2001 (China Statistical Yearbooks).

*(2) Experimentation and learning by doing*

Pragmatism, trial and error, evidence-based policy making, and experimentation with small scale policy reforms that are later scaled up, are all key features of China's reforms. Most successful reforms have experienced pilot experiments and impact evaluations before being scaled up. Learning by experimentation is a key strategy when reformers face huge economic and political uncertainty. When facing choices never seen before, it is extremely risky for agents to make radical choices. For any reform goal, there are potentially many different paths to take (Lou, Chapter 3, this volume). Due to uncertainty, it is hard to judge which option is more feasible from the *ex ante* point of view. In such circumstances, experimentation can be a useful tool to search for more information and for testing and updating prior hypotheses. Experiments yield information to help understand what works and what does not. Thus, even failures can be helpful because they can help eliminate unfavorable options, as shown by Luo (2008). The failure of his laissez-faire price reform experiment in Hebei Province helped him come up with the idea of dual-track price reform, which is an important example of an experiment where "Washington Consensus" wisdom was contradicted. Moreover, experimentation can help control the possible disastrous consequence of wrong choices. A wrong choice, at large scale, may be irreversible, and therefore may undermine the credibility and stability of the political leadership, and weaken overall learning capacity.

An important point to note here, in the context of emergence of randomized microeconomic experiments within development economics (Duflo, 2005), is that most of China's experiments were *not* random. Specifically, experiments were often initiated in isolated poor areas. As shown in the chapter by Du (Chapter 4, this volume), the leaders purposively initiated the household responsibility system as a pilot reform in several remote provinces in order to avoid minimize the potential costs of failure and reduce the political resistances. Similarly, the Wenzhou area, which used to be a remote region in Zhejiang Province but is now one of the most dynamic regions in China, received special permission to be a pilot region for rural industrialization precisely because of its isolation at the time (Zhu, 2008). Under the special policy, Wenzhou made bold experiments in reforming town-village enterprises (TVEs) and legalizing private firms. After observing its success, most TVEs and small and medium SOEs were privatized nationwide by the late 1990s. Although such experiments were not so rigorously conducted

as to include control groups, the pilots enabled researchers and policy makers to observe what worked and what did not on the ground. Another advantage of China's approach is that it involved an element of experimentation in macroeconomic reform, whereas contemporary randomized experiments are confined to microeconomic experiments (Rodrik 2008). Dual-track prices and special economic zones are two such examples.

Such experimentation has been particularly important in overcoming several major obstacles to effective reform in China, related to the country's size, its diversity, and the history and structure of its hierarchical political system. For a large and diverse economy like China, it is very difficult to derive a single one-size-fits-all blueprint for reform simply by applying textbook economic theories. Instead, trial and error processes can help discover local best practice. Second, the basis for formulating sound market-oriented policies in 1978 was limited. Few bureaucrats had any formal training in orthodox economics, nor even substantial experience of living in market economies. Chinese reforms therefore felt compelled to use experimentation as a collective learning mechanism. Moreover, successful Chinese reformers moved quickly to overcome China's limited research base by employing young recruits to work in think tanks, such as the China Rural Development and Research Center led by Mr. Du Runsheng, the author of Chapter 4 in this volume. Such institutions in turn helped overcome arguably the most binding constraint to effective decision-making in China, information asymmetry. Because China's bureaucrats are rewarded based on perceived merit, bureaucrats always have an incentive to falsify facts, as was the case in the Great Famine in which statistics on experimental yields were grossly falsified. Institutions such as the China Rural Development and Research Center played a key role in reducing these information biases by screening best practices and feeding them back to top policy makers (Keyser, 2003).

#### Pressure as a catalyst for reform

People evaluate the risks and payoffs with regard to the consequence of proposed policy change. However, they often have different (subjective) perceptions of the uncertainty related to change. Exogenous social, economic and political pressures – though adverse in some sense – can help policymakers induce policy reforms that, in calmer times, would generally be resisted.

The “pressure” which stimulated the earliest reforms of the post-1978 era was the threat of economic crisis. A crisis can have a silver lining in the context of reform in that it may help update people's

perceived risks and payoffs regarding alternative policy options, and thereby realign policy priorities so that new approaches emerge out of previous failures. So despite the negative effects of any crisis, crises necessitate change and re-examinations of current policies, in a manner analogous to Joseph Schumpeter's notion of creative destruction.

After the Cultural Revolution (1966-1976) China was on the verge of collapse under the planned economy system. More than two thirds of the people lived under one dollar per day (Ravallion and Chen, 2007, chapter 5 in this volume). With stagnant agricultural growth and fast population growth, food was in short supply. At the onset of reform, it seemed China faced extremely high barriers to escaping the low-level equilibrium trap where poverty persisted. However, as shown in chapter 4 by Du, one of the architects of China's rural reform, crisis may trigger reforms. After the end of Cultural Revolution, most of the top leaders and the masses realized that the planned system was not a viable option anymore, even if there was still uncertainty and debate as how next to proceed. Under these circumstances, top leaders were more willing to listen to different opinions and allow open policy debate. In other words, the crisis provided would-be reformers with a window of opportunity to push new agendas. Significant reforms do not come automatically and require policymakers to "seize the day" in a timely fashion.

One noted example is the rural reform documented by Du. Chinese farmers, who had suffered terribly under the Great Famine in the late 1950s and early 1960s, still had a vivid memory of the disaster, and knew that collective farming did not work, especially in times of crisis. So with another imminent weather shock looming in 1977, the local government in Fengyang County, Anhui Province – the province hardest hit by the famine in the late 1950s<sup>3</sup> - decided to contract the collective land to farmers because they knew the collective farming system could lead to another famine in the event of severe shocks. Yao (2007) provides an extensive review of land tenure changes in rural China and how the HRS was successfully scaled up (again, largely because farmers elsewhere had similarly critical views of collective farming).

China's joining the World Trade Organization (WTO) is another example of the use of an external pressure to invoke and lock in reform. In the 1990s, banking reform met enormous resistance because State banks did not want to give up their monopoly positions. Many local governments also opposed the

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<sup>3</sup> According to Yang (1996), the mortality rate in Anhui jumped from 11.9 in the period of 1956-58 to 68.6 per thousand in 1960, the highest among all the provinces.

reform because they were afraid of losing their ability to direct credit, which made it very difficult for State banks to really operate as commercial banks. Largely as a means of forcing further reforms in the banking and other key sectors, the top leaders made a bold move to enter China into the WTO. Although the WTO gave domestic banks a few years window of protection, in the end, most of the barriers to entry in the banking sector had to be removed such that State banks were eventually forced to compete on a level playing field. By using external pressure from the WTO accession the government was able to induce a series of reforms within State banks. Although not complete, most Chinese banks have shed off bad loans, several major state banks have listed their stocks in overseas markets and are subject to the scrutinizing of international financial markets, and local bank branches now find it much easier to refuse loans to local officials. Thus the use of external pressure largely achieved its implicit goals.

#### A note on the compatibility of economic and political explanations of the Chinese miracle

We have discussed four basic types of explanations of China's remarkable economic success: (1) "comparative advantage" (and conditional convergence); (2) "incentives matter" (fiscal decentralization and realignment of incentives towards growth-maximizing activities); (3) experimentation (as an economic and political discovery mechanism); and (4) pressure and crisis as inducers of reform. We conclude this section by noting that all these explanations are highly compatible and complimentary with each other, and that together they comprise a compelling and holistic explanation of China's economic miracle.

This holistic explanation of China's success, which incorporates both the outsiders' and insiders' viewpoints, runs as follows. The conventional economic explanation of China's growth – more efficient utilization of China's existing endowments – convincingly accounts for the proximate causes of China's growth, but does not explain the cause of reform or why the process of reform itself was so successful both politically and economically. The successful process of reform is in turn compellingly explained by both the "incentives matter" and "experimentation" arguments. Indeed, both arguments invoke several of the same ingredients of successful reform, such as overcoming information asymmetries by deriving local solutions to local problems, and discovering comparative advantage through trial, error and observation. Experimentation and marginal reforms, however, also served to overcome political constraints to reform by compensating would-be losers of reform, and convincing potential opponents of the benefits of reform by reducing the uncertainty of outcomes of reform. Finally, the catalyst for

reform was an economic and political crisis that jolted Chinese leaders, and to some extent its ordinary people, into reevaluating their mental models of where the Chinese economy should be heading. This story need not preclude other factors, such as the importance of good leadership (Jones 2005) or good luck, but together these four arguments certainly provide a compelling explanation of three decades of rapid economic growth.

### **3. After three decades of growth: the challenges of the present and the future**

After three decades of spectacular economic growth in China, the problem is no longer how to achieve growth but how to manage growth's consequences and how to sustain growth. China's spectacular growth and poverty reduction has been accompanied by rising inequality, environmental degradation, and increasing social tensions. The institutions that have brought rapid growth so far are now under stress, and there is a need to reform and innovate on this front in order to sustain rapid growth, and to obtain growth with equity (Lindbeck, 2008, Chapter 10 in this volume; Ji, Chapter 11 in this volume).

Rising inequality is one of China's most serious problems (Demurger *et. al.*, 2007, Chapter 7 in this volume; Benjamin, Brandt and Giles, 2005, Chapter 8 in this volume). In particular, the regional dimension of inequality - rural/urban and inland/coastal - dominates in a country as large as China, and especially with its particular history. Regional inequality has become a key issue for China and a number of interventions have been introduced to address the problem. These are discussed in Fan, Kanbur and Zhang (2009).

As shown by Kanbur and Zhang (2005, Chapter 6 in this volume), the pattern of China's regional inequality closely follows the history of its development strategies in the past half century. The heavy industry oriented development strategy justified the creation of the household registration system (*hukou*) which was a major contributor to the large rural-urban divide. The open-door policy, which granted preferential treatment to coastal areas, has helped the coast to better exploit its comparative advantage in the international markets, but left many interior provinces lagging behind. Similarly, fiscal decentralization policy promoted local government officials to develop their own economies, but differences in initial endowments tends to leave the effective tax rate regressive across Chinese regions (Zhang, 2006b). Regions with better endowments thereby have more revenues left to invest in public goods and improve business environment after turning over a portion of their fiscal revenues to the upper level government and maintaining the daily operation of local government. In contrast, the local

governments in poor regions have difficulty in competing with the governments on the coast to attract investment and develop the local nonfarm economy. Their local revenues are sometimes barely sufficient to cover the salaries of civil servants on the public payroll. Consequently, they are more likely to levy heavy taxes on existing enterprises, worsening the business investment environment. In summary, the successful development strategies mentioned in the above section also have some deleterious side effects.

In responding to rising rural-urban disparity and stagnating agricultural growth, China has launched a new rural movement campaign in the past several years (Chen, Chapter 3 in this volume). Agricultural taxation has been abolished, the government has provided direct subsidies for grain production. However, significant challenges still remain. Facing rising food and fuel prices, the government has placed a ceiling on the grain procurement price, which may dampen farmers' incentives to increase grain production in the long run.

The inter-juridical competition is a key contributing factor to the increasingly serious environmental problems. In order to attract investment, many local governments loosen their environmental regulations to allow polluters to operate as long as they generate lucrative revenues for the local government. In the rapidly industrializing coastal areas, such as Jiangsu Province and Zhejiang Province, the degree of water pollution and industrial waste hazard is alarming. The cost of cleaning up the environment problem may eat up a large portion of the gains from industrialization.

The investment-driven growth model also induces local officials to collude with investors at the expense of the rights of individuals (Zhang, 2007; Chow, Chapter 9 in this volume). In order to attract investment, many local governments provide preferential treatment to investors, such as free land. In the process of procuring farming land for industrial or other commercial use, the compensation to farmers was often far below the market level. Resenting this unfair treatment, many relocated farmers filed petitions to the upper level government for help, and land disputes have become a breeding ground for social unrest all over China (Yu, 2003). How to make local government officials accountable has become an increasingly important issue.

#### **4. Concluding Remarks**

China's experience since 1978 has taught economists many lessons about the process of development, but also about the study of economic development. Our reading of China's history, and of the

explanations that economists have proposed to explain that history, reiterate the increasingly accepted conclusion that while economic principles may be universal ingredients of successful development strategies, the specific recipes that embody these principles tend to be highly context-specific (Rodrik 2007, Headey 2008,). For example, China's strategy contains all the usual elements of successful development – getting incentives right, adhering to comparative advantage, providing secure (but often not private) property rights, investing in human capital, and achieving rapid agricultural growth – but the path which China took from plan to market was almost entirely distinct.

This confirmation of China's adherence to these principles should not be underestimated, but China's unique history, its enormous size, and its distinctive economic system should also remind us that China's specific reform strategies are unlikely to apply to other developing countries, especially small countries and those with very different institutional histories. For example, small countries that rely heavily on external donors for both finance and technical assistance will typically have a limited policy space in which to formulate heterodox policy solutions. Similarly, democracies, even democracies of similar size such as India, have limited ability to experiment the way China did. Nor do they typically provide such strong incentives for bureaucrats or elected officials to maximize growth.

Given the uniqueness of Chinese history, perhaps the key lessons of China's reform experiences are most valuable for China itself. With rapid economic growth and ballooning revenues, policymakers can easily become complacent and over-confident, ignoring the pragmatic and experimental approaches of yesteryear. Data collected by Heilman (2008) shows that the proportion of policy reforms with experimentation components has declined from around 50% in the 1980s, to 40% in the 1990s, and down further to just 20% since 2001. These statistics are consistent with what is being observed on the ground. The new labor contract law (Cheung, 2008), which was passed without little experimentation and limited consultation in 2007, is a noted example. The law generates much controversy in China. For example, the law stipulates that an employer must sign an open term contract an employee after finishing two fixed term contracts. This greatly discourages firms from hiring workers. The reform stories presented in this volume highlight the virtue of pragmatism and experimentation in the reform process. To overcome the emerging challenges, it is important for Chinese policymakers to maintain a pragmatic attitude to reform, and to keep focusing on innovations from the ground. When policy makers become more complacent, they are more likely to make centralized autocratic decisions, neglecting the wisdom of local knowledge and the virtues of experimentation. In essence, China runs the risk of kicking away the ladder by which it has reached its current heights. This is a key lesson for China, from itself.

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Appendix

**Governing Growth in China: Equity and Institutions**

Edited by

Ravi Kanbur and Xiaobo Zhang

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[Keynote Address at the 2006 Chinese Economists Society Conference]

3. Twenty Years Review and Deliberation: The Choice of Priorities in Reform.

*Jiwei Lou*

[Keynote Address at the 2006 Chinese Economists Society Conference]

4. The Course of China's Rural Reform.

*Runsheng Du*

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*Martin Ravallion and Shaohua Chen*

*[Journal of Development Economics, 82 (1): 1-42, 2007.]*

6. Fifty Years of Regional Inequality in China: A Journey Through Central Planning, Reform and Openness,"

*Ravi Kanbur and Xiaobo Zhang*

*[Review of Development Economics, 9 (1): 87-106, January 2005.]*

7. Economic Liberalization and Rising Segmentation in China's Urban Labor Market,"

*Sylvie Demurger, Martin Fournier, Li Shi and Wei Zhong*

*[Asian Economic Papers, 5(3): 56-99, 2007.]*

8. The Evolution of Income Inequality in Rural China

*Dwayne Benjamin, Loren Brandt, and John Giles*

[*Economic Development and Cultural Change*, volume 53 (4), (2005), pages 769–824.]

9. Rural Poverty in China: Problem and Solution

*Gregory Chow*

[Keynote Address at the 2006 Chinese Economists Society Conference]

**PART III Governance and Institutions**

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11. Redefining Relations Between the Rule of Law and the Market

*Weidong Ji*

[Keynote Address at the 2006 Chinese Economists Society Conference]

12. Political Turnover and Economic Performance: The Incentive Role of Personnel Control in China

*Hongbin Li and Li-An Zhou, 2005*

[*Journal of Public Economics*, 89: 1743-1762, 2005.]

13 .The Lessons of China's Transition to a Market Economy

*Justin Yifu Lin, Fang Cai and Zhou Li*

[*Cato Journal*, Volume 16 (2), 1996]

14. Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style,"

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