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The vexing paradoxes of China's evolving economy

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Commentary by

It is generally agreed that China's impressive economic achievements during the last three decades are largely the result of the radical reform of its economic system. While private ownership of firms hardly existed when these reforms started, private firms today account for about 60 percent of total production.

Ownership, however, is only one dimension of an economic system. China's economic system has changed just as drastically in other ways as well. Decision-making regarding consumption and production has largely been decentralized to individual households and firms, respectively; economic incentives, markets, competition, and internationalization have to a considerable extent replaced command, administrative processes, monopoly, and autarky. Generally speaking, China's reform period has been a stark contemporary illustration of the historical lesson that unleashing individual initiative tends to boost economic development.

How, then, should today's Chinese economy be characterized? Some observers describe China's current economic system as "state capitalism"; others (including China's rulers) call it "market socialism." Both labels mislead. One reason is the domination of private firms on the production side. Another is the fact that "socialism" usually does not rely upon strong economic incentives and competition, which are the dominant economic factors in today's China.

In fact, China is a type of mixed economy, with a number of specific features, some of which favor GDP growth, while others have not dragged down the economy to any considerable extent so far. But this situation is likely to change. So further reforms will be decisive in determining the Chinese economy's future performance.

Although internationalization of the economy has served China well, it is unlikely that the current 35 percent share of GDP claimed by exports and the heavy reliance on foreign technology are sustainable in the long run. Tension between widespread private ownership of firms and pervasive public ownership of assets is another specific feature of China's economic system that looks similarly creaky.

For example, by disfavoring lending to private firms, state-owned banks distort the allocation of resources. Chinese agriculture provides another example of tension between private entrepreneurship and public-sector ownership of assets. In particular, public ownership of land harms the investment incentives for family farms and reduces their chance of consolidating land holdings in order to exploit economies of scale.

Reducing this tension over ownership of firms and assets is imperative, because the entry and expansion of small private companies will be increasingly important when China's domestic markets and domestic innovation need to play a greater role. Thus, for China to gain maximum advantage from private entrepreneurship, it is important to continue shifting the share of financial assets and land holdings out of the public sector.

This would also help address the endemic corruption that is also a specific feature of the Chinese economic system. Corruption is difficult to reduce drastically so long as politicians and bureaucrats have much "to sell" to firms and individuals - including rationed loans from public-sector banks and regulatory permits of various types. In rural areas, corruption emanates from frequent expropriation of land-lease contracts held by farmers working on collectively owned land, which local officials then turn over to non-agriculture land developers. In both cases, reducing corruption will require not only government pep talks against bad ethics, but also institutional reforms, including further deregulation, stronger property rights, and more privately owned assets. Free media would also help.

No doubt, some types of corruption, including "asset stripping" in connection with the privatization of public-sector firms, has speeded up the emergence of a class of private capitalists and entrepreneurs. But if corruption becomes a permanent element of China's economic system, it is likely to both reduce the efficiency of the allocation of resources and damage the legitimacy of private entrepreneurship.

China also needs to shift from its highly "extensive" (resource consuming) growth strategy to a more "intensive" development path. Although high growth requires large-scale capital formation, the relation between investment in real capital assets and human capital in China seems to be out of proportion. This is reflected in the current investment ratio for real capital assets of 43 percent of GDP, compared to 4.3 percent investment in human capital in the form of education. China's growth would be more efficient if these proportions changed in favor of education, including vocational training, which is very poorly developed.

Moreover, eliminating today's vast wastage of natural resources, which underpins exceptionally high levels of pollution, will require a reformed regulatory framework, including higher user prices for energy, raw materials, and environmental resources. By shifting to a less resource-dependent development strategy, more resources would be available for improvements in the country's much neglected social arrangements, particularly among rural citizens and "urban outsiders" (individuals in informal urban sectors). This includes addressing China's patchy arrangements for income security, as well as its unevenly distributed provision of social services, such as health and education, in particular, in rural areas.

The case for combining further government withdrawal from the production system with more engagement in the social field is compelling. China's leaders seem to be promising this by voicing their concern for domestic entrepreneurship, social arrangements, rural development and environmental protection. Only time can tell to what extent, and how fast, such promises will be fulfilled.

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