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Change for the better

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It is generally agreed that China's impressive economic achievements during the past three decades are largely the result of the radical reform of its economic system. While private ownership of companies hardly existed when these reforms started, today they account for about 60 per cent 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 on consumption and production has largely been decentralised to individual households and companies, respectively; economic incentives, markets, competition and internationalisation have, to a considerable extent, replaced command, administrative processes, monopoly and autarchy. 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 characterised? Some observers describe China's economic system as "state capitalism"; others (including China's leaders) 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 on strong economic incentives and competition, which are the dominant economic factors in today's China.

In fact, China is a mixed economy, with specific features, some of which favour gross domestic product 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 internationalisation of the economy has served China well, it is unlikely that the present 35 per cent 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 companies and pervasive public ownership of assets is another feature of China's economic system that looks similarly creaky.

For example, state-owned banks distort the allocation of resources by not lending to private companies. Chinese agriculture is 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 holdings 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 feature of the Chinese economy. Corruption is difficult to reduce drastically as long as politicians and bureaucrats have much to "sell" to firms and individuals - including rationed loans from public-sector banks and various regulatory permits.

In rural areas, corruption emanates from frequent expropriation of land-lease contracts held by farmers working on collectively owned land, which local officials turn over to 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. A free media would also help.

No doubt, some types of corruption, including "asset stripping" in the privatisation of public-sector companies, 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, 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 per cent of GDP, compared with 4.3 per cent investment in human capital in education.

Growth would be more efficient if these proportions changed in favour 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 reforming the 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 will tell to what extent, and how fast, such promises will be fulfilled.

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