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Is Chinese Variety of Capitalism Really Unique?

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IS CHINESE VARIETY OF CAPITALISM REALLY UNIQUE?

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ABSTRACT

The formal comparison of similarities and differences of Chinese and Western economic models misses the most important point. The uniqueness of China is that it looks very much like a developed country today in terms of institutional capacity of the state, even though it is a developing country according to GDP per capita. Indeed, China should be compared with developing countries today or developed countries a hundred years ago, when their GDP was at the current Chinese level, and this comparison is very much in favour of China. Institutional capacity of the state, according to a narrow definition, is the ability of the government to enforce laws and regulations. While there are a lot of subjective indices (corruption, rule of law, government effectiveness, etc.) that are supposed to measure state institutional capacity, many researchers do not think they help to explain economic performance and instead consider them biased. The natural objective measures of state institutional capacity are the murder rate (noncompliance with the state's monopoly on violence4) and the shadow economy (non-compliance with the economic regulations). China is rather unique on both measures – one of the lowest indicators in the developing world comparable to developed countries.

[1] New Economic School, Moscow.

IS CHINESE VARIETY OF CAPITALISM REALLY UNIQUE?

Because the Chinese economy did much better in the recent recession of 2008-09, there is no shortage of articles suggesting that the Chinese model is more viable and that the West should learn from China.

"We in the West have a choice, - writes Anatole Kaletsky in "The Times". *Either we concede the argument that China, in the 5,000 years of recorded human history, has been a much more successful and durable culture than America or Western Europe and is now reclaiming its natural position of global leadership. Or we stop denying the rivalry between the Chinese and Western models and start thinking seriously about how Western capitalism can be reformed to have a better chance of winning"* [2].

"East is East, and West is West, and never the twain shall meet"?

Ever since Rudyard Kipling said it, his words were extensively cited and debated. Let us ask a more modest question however: does Chinese economic model *today* differ radically from the Western one, does it really have magic properties that allow growing amidst the world-wide recession or it happened just by the stroke of luck?

To be sure, Chinese economy is no longer either centrally planned or state-owned. On the similarities side we have:

- Dominant role of the private sector: 75% of GDP is produced at non-state enterprises, including joint stock companies and individual private businesses, which are not that different from their Western counterparts;
- Relatively small share of government spending in GDP (about 20%) – lower than in all Western countries and often lower than in developing countries with similar per capita GDP;
- No longer free education and health care and relatively high income and wealth inequalities (Gini coefficient of 45% and 64 billionaires only in the mainland, according to March 2010

[2] Anatole Kaletsky. "We need a new capitalism to take on China. If the West isn't to slide into irrelevance, governments must be much more active in taking control of the economy". "*The Times*". February 4, 2010 (http://www.timesonline.co.uk/tol/comment/columnists/anatole_kaletsky/article7014090.ece).

"Forbes' count, second place in the world – after the US with 403, but ahead of Russia with 62).

Differences with the Western economic model seem to be less significant:

- China has a strong export-oriented industrial policy – mostly in the form of undervaluation of yuan through accumulation of foreign exchange reserves. This is not without a precedent, however, since it was used by Hong Kong, Japan, Korea Taiwan and Singapore at earlier stages of development);
- Land is still not a private property in China and is not traded, but public ownership of land is not uncommon in other countries, albeit in smaller proportions;
- China exercises controls over the capital account, but it is used by many developing countries now and was used by European countries just half a century ago, after the Second World War;
- China has an authoritarian regime (which, of course, all developed countries had before, and some of them, like Spain, Portugal, Taiwan, South Korea, as recently as three-four decades ago).

Real difference – institutional capacity of the state

The formal comparison of similarities and differences of Chinese and Western economic models misses the most important point. The uniqueness of the China is that it looks very much like a developed country today in terms of institutional capacity of the state, even though it is a developing country according to GDP per capita. Indeed, China should be compared with developing countries today or developed countries a hundred years ago, when their GDP was at the current Chinese level, and this comparison is very much in favour of China.

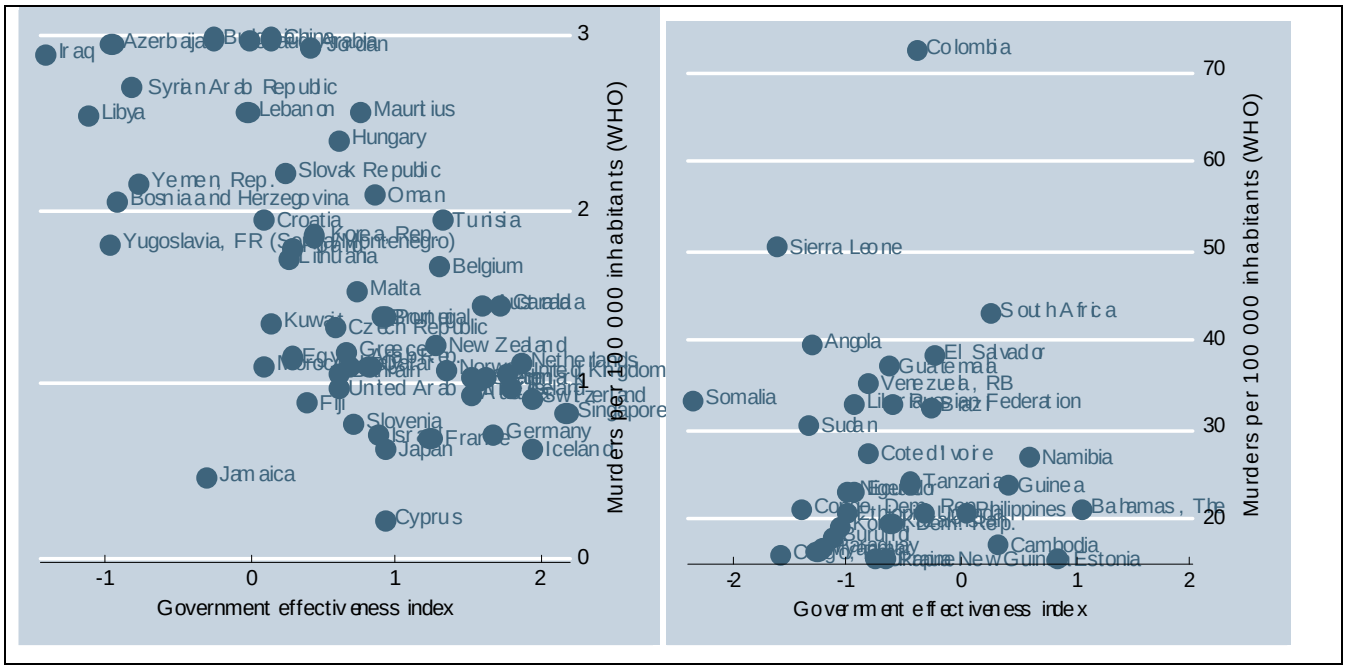
Institutional capacity of the state, according to a narrow definition, is the ability of the government to enforce laws and regulations. While there are a lot of subjective indices (corruption, rule of law, government effectiveness, etc.) that are supposed to measure the state institutional capacity, many researchers do not think they help to explain economic performance and consider them biased[3]. The natural objective measures of the state institutional capacity are the murder rate – non-compliance

[3] *Mushtaq H. Khan.* Governance, Economic Growth and Development since the 1960s. DESA Working Paper No. 54, August 2007. http://www.un.org/esa/desa/papers/2007/wp54_2007.pdf

with the state's monopoly on violence[4], and the shadow economy – non compliance with the economic regulations. China is rather unique on both measures – one of the lowest indicators in the developing world comparable to developed countries (see chart 1).

Chart 1. Murder rate per 100,000 inhabitants and government effectiveness index (ranges from -2.5 to +2.5) in 2002

Left chart – countries with low (0-3); right chart – countries with high (15-75) murder rate



Source: WHO, World Bank.

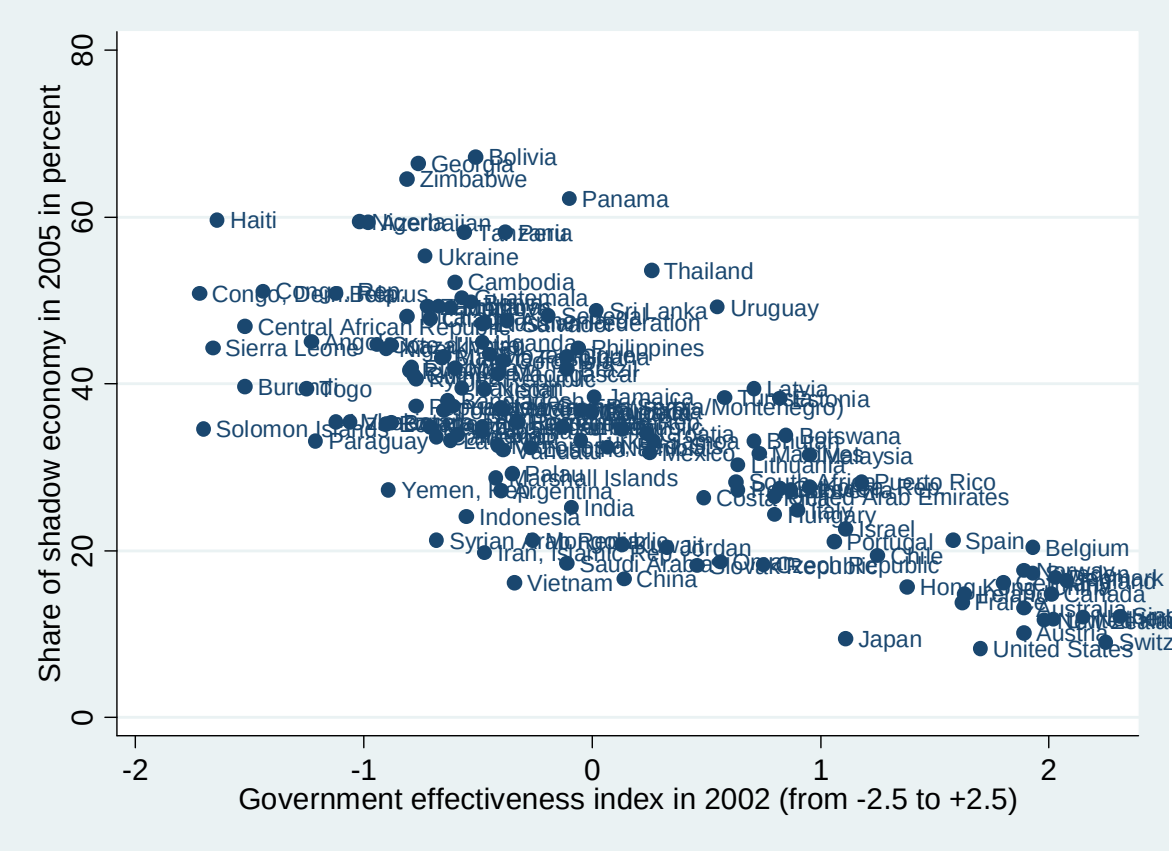
With less than 3 murders in 2002 per 100,000 inhabitants against 1-2 in Europe and Japan and over 5 in the US) China looks more like a developed country. Only a few developing countries, mostly in MENA region, have such low murder rates, normally they are higher by the order of magnitude, like in LA, SSA, many FSU states. By way of comparison, it took Western Europe 300 years to move from a murder rate of over 40 per 100, 000 inhabitants in the 16th century to current levels of 1-2 murders per 100, 000 inhabitants in the 19th century and beyond[5].

[4] Crimes are registered differently in different countries—higher crime rates in developed countries seem to be the result of better registration of crimes. But grave crimes, like murders, appear to be registered quite accurately even in developing countries, so international comparison of murder rates is well warranted.

[5] Eisner, Manuel. Long-Term Historical Trends in Violent Crime. – *Crime and Justice*, Vol. 30 (2003), pp 83-142.

The same with the shadow economy: it is less than 17% of the Chinese GDP, lower than in Belgium, Portugal, Spain, whereas in developing countries it is typically around 40%, sometimes even over 60%. Only few developing countries have such low share of shadow economy, in particular, Vietnam and some MENA countries (Iran, Jordan, Saudi Arabia, Syria).

Chart 2. Share of the shadow economy in GDP in 2005, %, and government effectiveness index in 2002



Source: World Bank. Data on shadow economy are from: Friedrich Schneider. Shadow Economies and Corruption All Over the World: New Estimates for 145 Countries. – Economics. Open Access, Open Assessment E-Journal, No. 2007-9 July 24, 2007 (measures of the shadow economy are derived from divergence between output dynamics and electricity consumption, demand for real cash balances, etc.).

Where does the strength of the Chinese institutions come from?

The pre-conditions for the Chinese success of the last thirty years were created mostly in the preceding period of 1949-76. In fact, it would be no exaggeration at all to claim that without the achievements of Mao's regime, the market-type reforms of 1979 and beyond would never have

produced the impressive results that they actually did. In this sense, economic liberalization in 1979 and beyond was only the last straw that broke the camel's back. The other ingredients, most importantly strong institutions and human capital, had already been provided by the previous regime. Without these other ingredients, liberalization alone in different periods and different countries was never successful and sometimes counterproductive, like in Sub-Saharan Africa in the 1980s.

Market-type reforms in China in 1979 and beyond brought about the acceleration of economic growth because China already had an efficient government that was created by CCP after the Liberation and that the country did not have in centuries. Through the party cells in every village, the communist government in Beijing was able to enforce its rules and regulations all over the country more efficiently than Qing Shi Huang Di or any emperor since then, not to mention the Kuomintang regime (1912-49). While in the late nineteenth century, the central government had revenues equivalent to only 3 percent of GDP (against 12 percent in Japan right after the Meiji Restoration) and under the Kuomintang government, they increased to only 5 percent of GDP, Mao's government left the state coffers to Deng's reform team with revenues equivalent to 20 percent of GDP[6].

The Chinese crime rate in the 1970s was among the lowest in the world, Chinese shadow economy was virtually non-existent, and corruption was estimated by Transparency International even in 1985 to be the lowest in the developing world (China, together with the USSR, was in the middle of the list of 54 countries – below Western countries, but ahead of most developing countries and ahead of South Korea, Greece, Italy, Portugal[7]). In the same period, during "clearly the greatest experiment in the mass education in the history of the world", literacy rates in China increased from 28 percent in 1949 to 65 percent by the end of the 1970s (41 percent in India)[8].

To put it differently, by the end of the 1970s, China had virtually everything that was needed for growth except some liberalization of markets — a much easier ingredient to introduce than human

[6] Lu, Aiguo. China and the Global Economy since 1840. New York, St. Martins Press, 1999.

[7] Internet Center for Corruption Research Historical comparisons.
Http://www.icgg.org/corruption.cpi_olderindices_historical.html

[8] Peterson Glen. State Literacy Ideologies and the Transformation of Rural China**.** *The Australian Journal of Chinese Affairs*, No. 32 (Jul., 1994.

capital or institutional capacity. And these foundations of the truly exceptional success of the post-reform period were laid in 1949-76.[9]

But even this seemingly simple task of economic liberalization required careful management. The USSR was in a similar position in the late 1980s. True, the Soviet system lost its economic and social dynamism, growth rates in the 1960s-80s were falling, life expectancy was not rising, and crime rates were slowly growing, but institutions were generally strong and human capital was large, which provided good starting conditions for reform. Nevertheless, economic liberalization in China (since 1979) and in the USSR and later in Russia (since 1989) produced markedly different outcomes.[10]

Manufacturing growth is like cooking a good dish—all the necessary ingredients should be in the right proportion; if only one is under- or overrepresented, the "chemistry of growth" will not happen. Fast economic growth can materialize in practice only if several necessary conditions are met simultaneously. In particular, rapid growth requires a number of crucial inputs — infrastructure, human capital, even land distribution in agrarian countries, strong state institutions, and economic stimuli among other things. Once one of the essential ingredients is missing, growth just does not take off. Rodrik, Hausmann, and Velasco talk about "binding constraints" that hold back economic growth; finding these constraints is a task in "growth diagnostics"[11] In some cases, these constraints

[9] To a lesser extent, this is true for India: market-type reforms in the 1990s produced good results because they were based on previous achievements of the import substitution period. Fast Indian growth is sometimes attributed to the deregulation reforms of the 1990s, but it was shown that it actually started in the early 1980s, well before deregulation reforms were launched (Ghosh, Jayati. Macroeconomic and Growth Policies. Background Note. UN DESA, 2007). Like the Chinese, Indian growth was based on the achievements of the 1950s-70s period of ISI and mobilization of domestic savings: the savings rate (as a % of GDP) doubled in recent 50 years, going up from 12-15% in the 1960s, to 16-20% in the 1970s, 15-23% in the 1980s, 23-25% in the 1990s, and to 24-35% in 2000-08.

[10] Popov, V. Shock Therapy versus Gradualism Reconsidered: Lessons from Transition Economies after 15 Years of Reforms. – *Comparative Economic Studies*, Vol. 49, Issue 1, March 2007, pp. 1-31 (http://www.nes.ru/%7Evpopov/documents/Shock%20vs%20grad%20reconsidered%20-15%20years%20after%20-article.pdf); Popov, V. Why the West Became Rich before China and Why China Has Been Catching Up with the West since 1949: Another Explanation of the "Great Divergence" and "Great Convergence" Stories. -NES/CEFIR Working paper # 132, October 2009.

[11] Rodrik, Dani, R. Hausmann, A. Velasco. Growth Diagnostics. 2005. Http://ksghome.harvard.edu/~drodrik/barcelonafinalmarch2005.pdf

are associated with a lack of market liberalization, in others, with a lack of state capacity or human capital or infrastructure.

Why did economic liberalization work in Central Europe but not in SSA and LA? The answer, according to the outlined approach, would be that in Central Europe, the missing ingredient was economic liberalization, whereas in SSA and LA, there was a lack of state capacity, not a lack of market liberalization. Why did liberalization work in China and Central Europe but did not work in CIS? It is because in CIS it was carried out in such a way as to undermine state capacity—the precious heritage of the socialist past — whereas in Central Europe and even more so in China, state capacity did not decline substantially during transition.

Unlike Russia after 1991, it so far seems as if China in 1979-2009 managed to better preserve its strong state institutions — the murder rate, a reliable measure of state capacity, in China is still below 3 per 100,000 inhabitants compared to about 30 in Russia in 2002 and about 20 in 2009. True, in the 1970s, under the Maoist regime, the murder rate in Shandong Province was less than 1[12], and in 1987, it was estimated to be 1.5 for the whole of China[13]. The threefold *increase* in the murder rate during the market reforms is comparable with the Russian increase, but Chinese *levels* are nowhere near the Russian levels.

If the Chinese model exists, is it replicable and sustainable?

The litmus test is a question on which economists sharply disagree: where the next economic miracles will occur, if at all?

Today, the conventional wisdom seems to point out to democratic countries encouraging individual freedoms and entrepreneurship, like Mexico and Brazil, Turkey and India, as future growth miracles,

[12] Shandong Province database [Shandong sheng shengqing ziliaoku]. Http://www.infobase.gov.cn/bin/mse.exe?seachword=&K=a&A=16&rec=42&run=13. Chinese PPP GDP per capita in the 1970s was about $1000 – at the same level as in Western Europe in the 17th century, when the murder rate was about 10 per 100, 000 inhabitants (Eisner, op.cit; Maddison, Angus. Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD (http://www.ggdc.net/maddison/).

[13] WHO Health for All Database, 2004.

whereas rapidly growing currently authoritarian regimes, like China and Vietnam or Iran and Egypt, are thought to be doomed to experience a growth slowdown, if not a recession, in the future. According to Jack Goldstone[14], "a country encouraging science and entrepreneurship will thrive regardless of inequality: hence India and Brazil, and perhaps Mexico, should become world leaders. But I say countries that retain hierarchical patronage systems and hostility to individualism and science-based entrepreneurship, will fall behind, such as Egypt and Iran". Many believe that rapid growth could be achieved under authoritarian regime only at the catch up stage, not at the innovative stage: once a country approaches the technological frontier and it becomes impossible to grow just by copying innovations of the others, it can continue to advance only with free entrepreneurship, guaranteed individual freedoms and democratic political regime[15].

This may be true and may be not, we still do not have enough evidence for the innovation-based growth. For one thing, on all measures of patent activity, Japan, South Korea and China are already ahead or rapidly catching up with the US. The patent office of the United States of America, which consistently issued the highest number of patents since 1998, was overtaken in 2007 by the patent office of Japan. The patent office of China replaced the European Patent Office as the fourth largest office in terms of issuing grants (the five largest patent offices (the patent offices of Japan, the USA, the Republic of Korea, China and the EPO accounted for 74.4% of total patent grants). The number of resident patent filings per $1 of GDP and $1 of R&D spending is already higher, sometimes considerably higher, in Japan, Korea and China than in the US[16].

And the evidence for the catch up growth is controversial to say the least. Imagine, for instance, that the debate about future economic miracles is happening in 1960: some are betting on more free, democratic and entrepreneurial India and Latin America, whereas the other predicted the success of authoritarian (even sometimes communist), centralized and heavy handed government interventionist East Asia…

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[14] Goldstone, J. Unpublished comments on Popov, V. Why the West Became Rich before China and Why China Has Been Catching Up with the West since 1949: Another Explanation of the "Great Divergence" and "Great Convergence" Stories. -NES/CEFIR Working paper # 132, October 2009.

[15] Ronald Inglehart and Christian Welzel. Modernization, Cultural Change, and Democracy: The Human Development Sequence. Cambridge University Press, 2005.

[16] World Intellectual Property Indicators. WIPO, Geneva, 2009.

What is unknown, however, is whether the gradually weakening in the reform period capacity of the Chinese state will continue to weaken further, which will convert China into a "normal" developing country. In this case Chinese rapid growth would come to an end and there wouldn't be any more a question of what is so special about the Chinese economic model.

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