5.2.1 Policy initiatives during the first decade of reform

_Agriculture and the rural economy._ The central feature of China’s rural reform was the return of household farming. Initially permitted as an experiment in a few poverty-stricken areas, the “Household Responsibility System” (HRS) spread rapidly as villagers “voted with their feet” to abandon collective agriculture in favor of the new system, which established what amounted to a system of tenancy, with cultivators paying fixed rents to the local government and retaining marginal earnings for themselves. Along with the HRS, the reform raised state procurement prices for grain and relaxed controls over rural markets for both products and farm inputs.

These reforms elicited an explosive response (Justin Lin 1988, 1992). Grain output rose by almost a third between 1978 and 1984, with output of cash crops and farm sidelines growing even more rapidly. Equally important, rapid productivity growth in farming freed up a large pool of labor formerly trapped in collective agriculture (Thomas Rawski and Robert Mead, 1998), which combined with a growing supply of agricultural goods, rising household incomes, and freeing up of markets for both inputs and outputs sparked a massive boom in rural industry, especially in China’s coastal provinces (Chris Bramall 2009, chap. 3). Within less than fifteen years, employment in China’s township and village enterprises expanded by nearly 100 million. The success of both the HRS and township and village enterprises demonstrated the remarkable resilience of a tradition of private contracting in an environment of vaguely defined property rights and pervasive political patronage.

_Globalization._ Following a period of intense debate in which, as in late Qing, conservatives insisted that international contacts threatened to erode the cultural foundations of Chinese society (LI Lanqing 2009, ZHAO Ziyang 2009), the PRC embarked on policy of gradual opening, initially focused on the establishment of four Special Economic Zones in the southern coastal provinces of Guangdong and Fujian, along with increased autonomy for those provinces to approve foreign investments and retain foreign exchange earnings.
After an initial period of confusion, the new zones powered a steep increase in labor-intensive manufactured exports. Guangdong and Fujian moved quickly to welcome investments by overseas Chinese entrepreneurs, many of whom had family ties to those provinces. Overseas investors were classified as “compatriots” (tongbao) rather than “foreign merchants” (waishang) and accorded special privileges. China benefited enormously from a historical accident: Beijing’s decision to allow inflows of foreign direct investment came just as steep increases in labor costs prompted Taiwanese and Hong Kong entrepreneurs to seek new locations for their labor-intensive export operations. This resulting marriage of ethnic Chinese business operators with Chinese migrant workers provided a massive boost to nascent reform efforts and launched China on a trajectory toward its current status as “workshop of the world.”

Foreign direct investment focused on labor-intensive export production soon spilled beyond the zones to encompass China’s rapidly expanding rural factories, first in Guangdong and Fujian, and then to other coastal provinces. When early experiments with openness were seen to generate large benefits, regional competition sparked growing enthusiasm for expanding foreign trade and investment, with officials at every level scrambling to capture opportunities linked to growing flows of trade, inward foreign direct investment, and (perhaps most important) inflows of knowledge and information, both through personal interaction and via the gradual diffusion of telephone, fax, computers, and the internet.

At the same time, falling international transport costs and new computer/information technologies allowed large multi-national manufacturers to reduce costs by setting up far-flung supply chains to take advantage of international differences in capabilities and costs. These firms viewed China as a stable source of inexpensive and cost-effective labor; for China, the multi-nationals promised new inflows of capital, managerial knowledge, market access, and technology. This confluence of interests produced first a trickle, and then a torrent of capital inflows as local governments strained to attract top international companies. The initial emphasis was on export production, but China’s ongoing economic expansion sharpened the interest of multi-national firms in China’s domestic market as well. This encouraged

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74 Overseas Chinese visitors expressed dissatisfaction with the Xiamen SEZ during the summer of 1982, complaining that it was impossible to formulate a business plan because the SEZ authorities refused to specify the cost of critical elements including land, water, and electricity (1982 interview).
Chinese officials to hone their strategy of offering access to the domestic market in exchange for large-scale technology transfers to the foreign firms’ suppliers and joint venture partners.

As a result, China, formerly among the most isolated economies, moved rapidly to rejoin the global system of exchange. Between 1978 and 1993, official data show a rise in China’s trade ratio from 9.7 to 31.9 percent. At the same time, China began to absorb large flows of foreign investment.

**Enlivening state enterprises.** Between 1955 and 1978, the number of industrial enterprises increased from 125,000 to 348,000, output rose by a factor of 10, and employment expanded from 5.9 to 61 million workers. In 1978, state-owned enterprises contributed 77.6 percent of industrial production, with the remainder coming from collective firms, most controlled by local governments or state-owned firms. Most firms, most managers, and many workers had no market-economy experience. Firms carried out instructions. Pricing, advertising, marketing, selecting the product mix, and responding to market developments played no role in day-to-day operations. Observations from 1982 regarding two manufacturers of sewing machines illustrate pre-reform circumstances in Chinese state firms. When a Chinese visitor suggested that the work force at a Canton factory was three times the necessary size, the manger agreed, but said “if we did not employ them, where would they go?” At a large Shanghai plant, the manager repeatedly insisted that he did not know the unit cost of the products coming off his assembly line; his position: “our job is to produce sewing machines; costs are the concern of the general company office” (1982 interviews).

China’s reformers, dissatisfied with the passivity of firms that were intended to lead China’s economy, set out to “enliven” state-owned industry by injecting new incentives, flexibility, and technology. Neither privatization nor bankruptcy was considered. Instead, managers of state enterprises were granted greater autonomy in running their firms. Funding was shifted from grants to loans from newly established state-owned commercial banks. Hints of a labor market began to appear: retirees and

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75 Data in this paragraph are from Nai-ruenn Chen (1967, pp. 182, 475); Industry 2000, p. 21; Compendium 2010, p. 40; Yearbook (1991, p. 96).
76 Accounts of initial reforms affecting state-owned industry include Barry Naughton (1995) and Edward Steinfeld (1998).
workers with special skills concluded informal moonlighting arrangements with firms that could benefit from such services. Also, a new class of “contract” workers emerged without the lifetime job security promised to incumbent workers in state-owned enterprises.

Rather than transferring profits (and losses) to the state, firms were allowed to keep a share of their profits, which could be spent on new equipment, bonuses for workers and managers, or upgrading workers’ housing. To supply nascent markets, firms were allowed to find their own outlets for production that exceeded annual plan quotas, which in China tended to be considerably below actual capacity. In 1984, a new “dual track policy” institutionalized these initiatives, essentially partitioning almost all commodity markets into plan and market components. This horizontal bifurcation represents a genuine policy innovation, retaining the tax/subsidy elements implicit in plan allocations of inputs and outputs while revealing current information about marginal costs to agents throughout the economy.77

**Fiscal decentralization.** China’s early reforms included important fiscal changes. The new arrangements replaced the former unified system in which the center had controlled tax revenues and then assigned funds and responsibilities to lower governmental levels (tongshou-tongzhi). The new set-up divided revenue sources among various levels of government and included an array of multi-year fiscal contracts which committed lower levels of government to deliver specified revenue flows to the level immediately above them in the official hierarchy (Gabriella Montinola, Yingyi Qian, and Barry R. Weingast 1996). Combined with an ongoing trend toward decentralization of authority over economic management that began during the era of socialist planning, this change gave local governments the incentive, the resources, and the policy tools to promote local economic growth with an intensity and determination rarely visible in other economies. However, lower rates of growth and rapidly falling profitability in the state sector (Barry Naughton 2008, pp. 107-109), agency problems in the collection of central government tax revenue, and a combination of nominal tax contracting and inflation contributed to sharp erosion in central government tax revenue (Christine Wong and Richard Bird 2008).

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77 Under modest assumptions, this regime approaches Paul Samuelson’s vision of a market system with initial lump-sum transfers.
5.2.2 The role of political change

China’s initial decade and a half of reform rested on important political changes which allowed for and interacted with economic initiatives in ways that facilitated the economy’s gradual migration toward market-influenced outcomes.

With improvements in living standards central to re-establishing political legitimacy, China’s ruling Communist party shifted its objectives toward greater emphasis on economic growth, particularly at the intensive margin, and away from the sort of “ideological correctness” that had turned descendents of landlords, businessmen, or non-communist political leaders into pariahs and elevated “red” enthusiasm over “expertise” derived from knowledge and experience.

The CCP also reformed its internal structure to emphasize governance based on formal procedures rather than, as under MAO Zedong, on the personal inclinations of top leaders. Chenggang Xu (2010, p. 16) refers to the early years of reform as a “watershed period in which the CCP began to transform itself from a ‘personality-ruled party’” into what Susan Shirk (1993) describes as “a system governed by rules, clear lines of authority, and collective decision making institutions.” The changes included a strong effort to establish personnel policies that would install objective criteria rather than seniority or personal ties as the chief determinants of appointments and promotions.

Elite recruitment reflected this shift, as both government and party welcomed new graduates of China’s universities following the revival of merit-based admissions beginning in 1977. The expansion of elite recruitment gradually encompassed entrepreneurs and other former pariahs: the rehabilitation of RONG Yiren, a Christian-educated entrepreneur, disgraced during the Cultural Revolution, but then tapped in 1978 to establish the China International Trust and Investment Corporation (CITIC), “the investment arm of the Chinese state” and eventually appointed to the ceremonial post of Vice President of China, epitomized this change (Economist 2005).

Of particular importance was a new system of performance evaluation for sub-national officials based on quantitative algorithms that assigned heavy weight to GDP
growth in the region under an official’s jurisdiction (Susan H. Whiting 2001). Facilitated by China’s M-form hierarchy, implementation of these personnel policies inspired tournament-like competition among county magistrates and provincial governors, who recognized that accelerated economic growth would bring recognition and promotion, and made strenuous efforts to ramp up local economies.  The impact on official behavior has been profound, with reform-era career paths reflecting economic outcomes in jurisdictions governed by individual officials (Hongbin Li and Li-An Zhou 2005).

The newly evident vertical alignment of incentives spanning the CCP leadership, local and regional officials, and ordinary Chinese, most of whom stood to benefit from rapid economic growth, helped to reduce the agency costs inherent in any system of governance in a nation of China’s size and probably strengthened the capacity of China’s government and party leaders to shape the behavior of lower-level officials assigned to implement the center’s policy decisions (Barry Naughton 2011).

Under the PRC’s highly authoritarian political system, policy objectives are defined by the Party. However, the reform period also witnessed the refinement of a system of policy experimentation with deep historical roots – both during the pre-1949 experience with land reform and other matters in Communist-controlled base areas, and, at greater remove, during the imperial era, when local experimentation gave birth to the nationally-implemented likin (lijin) tax on domestic trade during the second half of the 19th century. Sebastian Heilmann traces Chinese Communist experimentation, particularly in the area of land policy, back to the 1930s, and identifies "experimentation under hierarchy . . . the volatile yet productive combination of decentralized experimentation with ad hoc central interference, resulting in the selective integration of local experiences into national policy-making" as “the key to understanding China’s policy process” (2008, p. 29). Under this system, proponents of specific policies promote experimental implementation. Successful trials generate information that buttress recommendations for widespread implementation; skeptics can review such reports and inspect the trial sites. If trials fail, costs to the national economy are slight. Of course, the advantages of such experimentation depend on

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78 Montinola, Qian and Weingast provide examples of such behavior (1995, p. 74).
sufficient local autonomy to allow trial implementation, critical review of initial results (notably absent from 1958 until the early 1970s), and the capacity to ensure widespread implementation of successful initiatives (often absent during the imperial era).

5.2.3 Assessment of the first decade and a half of reform

Despite obvious limitations, we can see in retrospect that China’s initial reforms – economic as well as political – represent a watershed in Chinese economic history. For the first time, China’s economy avoided most of the Qing-era institutional constraints as well as the most restrictive of the fresh obstacles imposed by the PRC. With the environment of the 1980s and early 1990s still far from ideal, and powerful restraints still limiting both domestic markets and global participation, the scale of the response to new opportunities, which astonished both domestic and overseas observers, attests to the underlying potential of capabilities and behavior patterns inherited from the decades and centuries prior to 1949 as well as the scale of human and physical capital accumulation under the PRC.

The greatest success occurred in the rural economy, where the explosive response to implementation of the household responsibility system banished the specter of food shortages and sparked the largest episode of poverty alleviation in human history (Martin Ravallion and Shaohua Chen 2007; Thomas Rawski 2011b). China’s rural economic revival went far beyond an intensification of effort in response to the restoration of individual incentives. The reform unleashed a torrent of entrepreneurship replete with written contracts, formation of supply chains and market networks, circumvention of official restrictions, bribery, and profiteering – a veritable census of way-stations along the “capitalist road” that an unceasing stream of pronouncements, speeches, regulations, documents, campaigns, and exhortations had denounced, restricted and often punished during China’s twenty years of rural collectivization.80

Similar phenomena appeared in the cities. Dwight Perkins observed that “when China stopped suppressing such activity ... Shops, restaurants and many other service

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80 Typical descriptions include Anita Chan, Richard Madsen and Jon Unger (1992, pp. 271-282) and Thomas Lyons and Victor Nee (1994).
units popped up everywhere … [because] Chinese … had not forgotten to trade or run a small business” (1995, p. 231). This sudden reappearance of an extensive entrepreneurial repertoire following a lengthy hiatus signals the contribution of human capital legacies to China’s recent boom and underlines the persistence of “stock[s] of knowledge transmitted from generation to generation” including “practical knowledge, or ‘knowing how’ … [leading to] shared behavioral regularities or shared routines within a population” (Chris Mantzavinos, Douglass North and Syed Shariq 2004, p. 77).

Rapid expansion of international trade and investment eliminated long-standing shortages of foreign exchange, began to tap the wealth and expertise of Overseas Chinese and of multinational corporations, and introduced a long-absent element of economic rationality into investment policies by channeling resources into labor-intensive export production that matched China’s resource endowment.

Efforts to upgrade state enterprises were far less successful, and losses mounted despite massive direct and indirect subsidies. Throughout much of the 1980s, China’s economy was a halfway house combining elements of old and new. While the plan system, the state sector, and the official allocation of resources – especially labor and capital – remained much in evidence, the reform policies of agricultural liberalization, domestic market expansion, international opening, and fiscal decentralization contributed to growth, to the acquisition of new knowledge, and, especially along various margins, to a substantial injection of market forces and pressures into the economy.

Although the reform process spawned episodes of social unrest – the 1989 Tian’anmen protests in part reflected public anger over inflation and corruption – several features acted to limit the social friction arising from the initial reforms. Most importantly, the first fifteen years of reform produced no substantial group of losers – a rare outcome in episodes of substantial socio-economic change (Lawrence J. Lau, Yingyi Qian, and Gerard Roland, 2001). In general, the early reforms mainly affected resource flows: adjustments of stocks in the form of layoffs, bankruptcy, or privatization were notably absent.

Reforms such as the dual-track system, which protected the absolute value of the economic rents of the planners, even if they subsequently declined significantly as a
percentage of GDP, have been singled out in this regard. In addition, potential losers of reforms often became its strongest advocates and beneficiaries. Dissolution of collective farming undermined the power and perquisites of local rural leaders, but the same set of reforms simultaneously endowed them with new opportunities, often as entrepreneurs or enterprise managers of new or formerly commune and brigade-run enterprises, roles that enabled them to turn political networks into economic assets. Similarly, the retreat from planning brought widespread commercialization of government agencies (partly in response to the fiscal squeeze described earlier), which enabled government officials to turn what began as a reduction in their authority into economic gain.

Equally if not more important, however, was the massive redistribution of resources from China’s rapidly growing and dynamic non-state sector, to a sluggish state sector. Wages and employment in the lagging state sector were largely able to grow because of ongoing injections of credit through China’s highly repressed and state controlled financial system. Rapidly rising saving rates and few alternatives for these savings—a product of financial repression—meant that much of the increase in savings ended up in China’s state-run banks, which in turn recycled them to state-linked firms and institutions. Estimates put these flows in upwards of 10% of GDP by the late 1980s/early 1990s (Loren Brandt and Xiaodong Zhu, 2000). These flows helped to ensure that the gains from rapid growth were more equitably shared than otherwise would have been the case.

5.2.4 Political and economic change since the mid-1990s

Despite fifteen years of GDP growth averaging eight percent per annum, China reached a critical crossroads in the early 1990s. Growth had become highly cyclical, with successive periods of liberalization and reform accompanied by high growth but also higher rates of inflation. Soft budget constraints in the state sector saddled the state-owned banks with portfolios dominated by non-performing loans. Finally, central government fiscal revenue had fallen to twenty percent of total fiscal revenue, and only 3 percent of GDP. In various ways, these problems can be linked to one central issue: persistent costs associated with China’s bloated, plodding, and often inefficient state-
owned enterprises that manifest themselves in the form of excessive state-sector employment, weak management, lax labor and financial discipline, rising losses, and overdue debts.

In the mid-1990s, China’s policy-makers attacked these difficulties with a remarkable sequence of policy changes following the Chinese Communist Party’s November 1993 decision to adopt the long-term objective of building a “socialist market economy” that were designed to limit government’s role to macroeconomic control; prudential regulation of such matters as competition, social safety nets, health and environment; and strategic planning, with other choices to reflect the outcome of market processes. The ensuing policy resulted in a sweeping overhaul of the fiscal system that sharply increased the center’s fiscal strength (Wong and Bird 2008).

Reorganization of the financial system that tightened central control, strengthened the authority of the People’s Bank of China (China’s central bank), removed non-performing loans from the balance sheets and recapitalized state-owned banks, increased the commercial orientation of bank operations, and reduced the power of provincial and local officials to influence lending decisions (Franklin Allen, Jun Qian, and Meijun Qian 2008; Gang Yi 2010).

Comprehensive restructuring of the enterprise sector, including the furloughing and eventual dismissal of over 50 million redundant employees, most in the state sector, substantial privatization of both state and collective enterprises, along with further reforms – including virtual elimination of planned allocation of materials – that sharply increased the market orientation of the remaining government-linked firms.

Broad embrace of globalization that transformed China into a major participant in global flows of commodities, capital, and technology (Lee Branstetter and Nicholas R. Lardy 2008). To this end, China reduced tariffs and other trade barriers in advance of its 2001 entry into the World Trade organization, established numerous economic zones and industrial parks to serve the needs of overseas investors, loosened restrictions on overseas travel and study for its own citizens, encouraged Chinese firms to invest


overseas, and allowed legal, tax, and regulatory changes initially restricted to special economic zones and coastal regions to apply throughout the domestic economy.

Major efforts to expand the market orientation of China’s economy, including extensive privatization and deregulation of domestic trade and transportation, general withdrawal of official involvement in pricing and allocation of labor and most commodities, and a rapid increase in the share of private businesses in output and especially employment, backed by new constitutional and legal provisions affirming the legitimacy of private ownership and the state’s responsibility to protect private (along with state and collective) property.

These reform efforts were far more systematic than during the early years of reform. They were also far more aggressive, in that reform proponents advocated and implemented measures that imposed substantial costs on large and potentially powerful groups, including urban state sector workers formerly lionized as the “vanguard of the proletariat” and state enterprises inundated with competition from imports following steep reductions in trade barriers. They were also not fore-ordained.

What critical factors allowed these new reforms to go forward? Interpretations differ, but several are prominent. First, the successes of reform, starting with developments in the rural sector, persuaded growing numbers of policy-makers to move beyond the 1980s slogan of “planned economy as the mainstream, with market allocation as a supplement” (jihuajingji wei zhu, shichang tiaojie wei fu). Despite the dismissal of reformist Premier ZHAO Ziyang and the partial rollback of reform initiatives following the June 1989 suppression of mass protests in Beijing and other cities, the momentum of reform thinking enabled the 1993 decision to move toward a “socialist market economy with Chinese characteristics.” The accompanying explanations pointed to a market outcome as the long-term goal. Thereafter, “the functions of the government in economic management gradually began to be confined to the spheres of macro-control, market supervision, social security, environmental protection, and management of state-owned assets” (HU Angang 2010, p. 169). Beyond these boundaries, allocation decisions were, in principle, to move toward market outcomes.

In this process, Yingyi Qian (2000) has emphasized the accumulation of experience among China’s leaders, who absorbed the lessons of China’s initial decade
of reform, studied international experience within and beyond the European transition economies and former constituents of the Soviet Union, and used the resulting knowledge to inform the evolution of Chinese policy. In this regard, rapid improvement in the quality and penetration of official and academic economic research, bolstered by the arrival of graduates trained at leading institutions throughout the developed world, may have convinced growing numbers of policy-makers that strong measures were needed to address long-standing problems such as the costly conflict between decentralization and supporting a large and diverse population of state-owned enterprises.

While recognizing the importance of this learning process, it is unlikely that this expanded reform effort could have unfolded without important political changes. Barry Naughton (2008) emphasizes the effect of personnel changes among China’s top leadership. During the 1980s and early 1990s, party elders and retired officials retained the capacity to block or veto measures that threatened interest groups – for example, workers in state-owned firms – with whom they were associated. Beginning in the mid-1990s, the death and decline of these “veto players” empowered JIANG Zemin, ZHU Rongji and their successors to undertake decisive, far-reaching moves that were formerly beyond the reach even of China’s highest officials.

Several additional political factors may have reinforced this trend. First, educational disruption during the Cultural Revolution decade (1966-1976) provided reformers with an acceptable rationale for discarding seniority-based promotion in favor of emphasizing personnel “quality” (suzhi), for which the metric is university or postgraduate training. The result - leapfrogging a generation of potential leaders whose main qualification was loyalty to the Communist Party and to MAO Zedong – surely accelerated the pace of market-oriented reform. Strong emphasis on educational attainment in recruiting for official positions and Party membership may have reduced the commitment of policy elites to planning and state ownership. Second, migration of policy-makers and administrators from dynamic coastal jurisdictions to interior regions eager to replicate the economic gains of places like Shenzhen and Shanghai may have homogenized views within the policy community. And third, promotion of

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83 Emphasis on educational credentials has created a strong demand for both full- and part-time training programs, as well as a lively market for forged credentials.
some of the same individuals to even higher positions of authority in both the CCP and government helped to further reinforce these trends.

6. Conclusion

6.1 China’s Economic Achievement

In 1800, China was the world’s largest national economy. Over the next 175 years, China’s relative position suffered a long decline. During the 1960s and 1970s, most Chinese had inadequate diets and no savings. Three decades of reform has produced a genuine leap forward in the size of China’s economy and the prosperity of its citizens. China’s recent boom has reshaped China’s economic structure, sharply lowering the importance of agriculture in production and especially employment, raising the share of industry and, more recently, of services, and beginning a protracted process of urbanization. Chinese producers and consumers are increasingly engaged with sophisticated technologies like smart phones, high-speed trains, and space exploration. Formerly state-controlled and internationally isolated, China’s economy now reflects the deep and expanding influence of domestic and global market forces.

6.2 Linking China’s Economy with the Past: Continuities and Departures

China’s enormous growth spurt has stimulated efforts to define a “Chinese model” of growth or to establish a “Beijing consensus” of development-enhancing policies (e.g. S. Philip Hsu, Yu-Shan Wang and Suisheng Zhao, 2011). This assumes that China’s economic, political, and social circumstances are sufficiently close to conditions prevailing in other low-income nations to expect that application of Chinese economic policies may produce something akin to the favorable outcomes that China’s system has delivered over the past several decades. Such assumptions seem unwarranted because of the deep historical roots surrounding important features of China’s current institutional structure and the central role of China’s unusual legacy of human capital in powering China’s recent economic surge.
We attribute China’s recent economic success to a combination of beneficial historic legacies, recent accumulations of capital, skill, and policy expertise, and important economic and political changes that facilitated the realization of old and new potentials. Despite the success of China’s imperial system in absorbing vast population increases, the administrative, organizational, and entrepreneurial skills, commercial and transport networks and other developmentally-promising resources visible in the Qing economy proved incapable of generating a rapid and effective response to new opportunities arising from the British industrial revolution. If historic accumulation of resources and capabilities deserves recognition as an important contributor to China’s recent growth, why does China’s boom begin only in the late 1970s?

To understand the long delay in China’s response to the new landscape of modern economic growth that unfolded during the 19th and 20th centuries, we propose to focus on institutional constraints. We view the trajectory of China’s 20th century economy as a gradual and as yet incomplete process of rolling back old and new institutional barriers standing in the way of prosperity and growth. We begin by comparing the Qing imperial regime with the reform-era People’s Republic, first noting major similarities, and then highlighting key institutional differences between the past and present Chinese systems.

6.2.2 Major institutional continuities

Our review reveals substantial areas of institutional continuity linking China’s past and present.

**Authoritarian system.** Major elements of institutional continuity begin with China’s authoritarian political system. In the People’s Republic, as under Qing rule, self-perpetuating elites exercise supreme authority with no formal checks and balances. Although the Qing memorial system and the Communist Party’s practice of democratic centralism provide avenues for lower ranking individuals to influence policy outcomes, decisions emanating from the throne or politburo are final. Despite the growing influence of international norms and practices over the structure and operation of China’s legal codes system, the tradition of strong official control over the administration of law and justice remains intact. Today, as in the past, political leaders
are free to decide matters that, in other societies, might be determined by legal codes or judicial verdicts.

**Personnel, agency and central-local tensions.** To implement central policies, both the Qing and the People’s Republic rely on centrally-managed, merit-based personnel systems. The Confucian approach emphasizing “rule of (properly trained, selected and motivated) men” rather than “rule of law” prevails. Both systems rely on a combination of ideology and oversight to limit the inevitable agency costs associated with granting substantial autonomy to lower-level officials, whose career prospects depend more on outcomes than on adherence to carefully prescribed procedures.

Monitoring is only imperfect however, and we observe similar agency problems today as in the Qing. Both regimes, for example, implement vigorous measures to curb what the center views as corrupt diversion of tax payments intended for the central treasury. The reform efforts of the Qing Yongzheng emperor (r. 1678-1735) failed to dent “informal networks of local power and influence” or to eliminate “the tax evasion and tax farming that [had] decreased the level of remittances” to the central treasury (Madeleine Zelin 1984, p. 307). These tensions persist: Vivienne Shue observes that rural administration in the PRC both before and after the start of reform “perpetuated the contained but unrelenting central-local struggle characteristic of imperial politics” (1988, p. 114). And today, local governments continue to resist Beijing’s efforts to limit the scale of taxation and fee collection. When the center eliminated taxation on farmers by village and township-level governments, local leaders turned the power of eminent domain into a new source of revenue by commandeering farmland with nominal compensation to the occupants and then reselling it for business use at much higher prices.

**Economic decentralization.** Both Qing and the People’s Republic combine centralization of political authority with relatively decentralized economies. The Qing economy was essentially a market system with private ownership. During the pre-reform decades under the People’s Republic, China’s planned economy, though patterned after the Soviet example, was far less centralized than the USSR’s, with provincial and local governments controlling a substantial fraction of state-owned enterprises and managing substantial resource flows. Reforms have only increased
these decentralizing tendencies, albeit within the context of a largely market economy in which upwards of two-thirds of ownership is private.

**Education, human capital and entrepreneurship.** The historical legacy of a national civil-service examination designed to support the administrative tools of imperial rule helped to make pursuit of education a hallmark of Chinese society throughout the past millennium. It also promoted remarkable cultural and ethnic homogeneity in a nation of China’s size. While PRC emphasis on mass education has delivered notable improvements in school attendance and other dimensions of human development, stocks of human capital accumulated long before 1949 contributed massively to China’s recent economic gains. Reflecting long-standing cultural values, three decades of negative financial returns for graduates,\(^{84}\) school closures and suspension of merit-based admissions during the Cultural Revolution (roughly 1966-1975), and persecution of intellectuals did not deter millions of Chinese families from emphasizing learning and study. Restoration of university entrance examinations in 1977 attracted swarms of self-taught candidates.

The legacy of human capital extends beyond reverence for education. The room allowed for small private plots and rural markets under collective agriculture helped to ensure that commercial instincts in the Chinese countryside were not totally extinguished, and contributed to the boom under HRS when small-holding agriculture once again dominated the countryside. Rapid expansion of production, employment, and exports in millions of “township and village enterprises” relied on China’s deep reserves of rural management capability, highlighting what Tim Wright has termed China’s historic “abundance of small-time entrepreneurs” (1984, p. 325).

**Alignment of Incentives.** The Qing achieved considerable success in aligning incentives among the throne, the bureaucracy, the gentry, and the common people – all of whom sought prosperity and stability. The plan era, during which the state called on ordinary Chinese to suppress their desire for better living standards for the sake of “building socialism,” emerges as a historical anomaly. Following the death of MAO

\(^{84}\) According to HOU Fengyun, “large-scale wage reductions for high-level mental workers” occurred in 1957, 1959, and 1961, and “mental workers. . . were mostly excluded” from wage increases in 1959, 1961, 1963 and 1971. Hou describes 1976-1990 as an era of “no payoff to education.” Apparently referring to the late 1980s, Hou notes that average monthly pay in universities was RMB57 less than in the food and drink sector (1999, pp. 181-185).
Zedong, reform policies restored the traditional unity of objectives, with leaders, officials, and populace all pursuing economic growth.

**Experimentation.** Chinese governments consistently preface major policy initiatives with local experiments, which form “an essential part of the central decision-making process” in China today (Chenggang Xu 2010, p. 31). Experimentation continues: in October 2011, four sub-national governments were authorized to issue provincial or municipal bonds85

### 6.2.2 Key institutional departures under the PRC

**Vision/objectives.** Like many of their British contemporaries (Deirdre McCloskey 2010, chap. 10), China’s Qing emperors failed to recognize the enormous potential returns associated with the Industrial Revolution. But even if the Qing had grasped the long-term prospects arising from steam engines, railways, and other new technologies, concerns that such forces would take on a life of their own and disrupt the delicate balance of power and alignment of interests that supported their continued rulership would probably have discouraged them from vigorous pursuit of new economic opportunities.

Reform leader DENG Xiaoping’s famous observations that “to get rich is glorious” and “it does not matter if a cat is black or white as long as it catches mice” mark the completion of century-long process that established economic opening and expansion as key elements in the objective function of China’s top leaders, who now see “economic growth as a life and death matter for the regime” (Chenggang Xu 2010, p. 13). Indeed, the capacity to deliver economic growth and high living standards constitutes a key source of legitimacy for Communist rule in the reform era. The roots of this ideology, which emphasizes economic development to improve citizens’ life chances and to enhance China’s capacity to thrive in a competitive world, originate with the weak Qing response to 19th-century imperialist pressures.

**Elite recruitment and absorption of newly emerging interests.** During the Ming-Qing era, elite status derived from examination success, which required

candidates and their families to undertake massive educational investments. Qing gentry resisted efforts to open the door to newcomers whose non-traditional mobility paths threatened to devalue traditional Confucian education (Carl Mosk 2010). They did so with good reason as the abolition of the traditional examination system (1905) and the collapse of the Qing dynasty (1911) produced a rapid decline in the financial payoff to Confucian learning: by the late 1920s, the returns to “modern” education had far surpassed the financial benefit from Confucian learning among employees of the Tianjin-Pukou railway (Noam Yuchtman, 2010).

Following the MAO years, which enforced even stricter ideological limits on its political elites and actively persecuted excluded groups, the reform-era PRC has broadened elite recruitment to include two major channels – education and wealth. The new combination of large, widely-shared economic gains and CCP reform enabling wholesale absorption of potential regime opponents into elite ranks has tilted policy-making in economically beneficial directions, while assisting official efforts to marginalize dissident groups.

State capacity. Building on experience accumulated in the administration of isolated rural areas during China’s protracted civil war and in the civil war itself, the PRC demonstrated unprecedented capacity to formulate, implement, and monitor nationwide policy initiatives that, for the first time in Chinese history, penetrated directly to the village level. Campaigns to expand attendance in school, reduce infant mortality, attack “rightists” and force villagers into collectives demonstrated the reach of these new administrative structures. With the right policies, often learned through the local experimentation described above, and incentives, these structures enabled a scaling up of efforts that were essential to delivering economic growth.

Globalization. Foreign military power compelled the partial opening of China’s 19th-century economy. The Qing government sought to limit the scope of foreign activity; individual foreigners, as well as their products and technologies, faced powerful informal opposition by local gentry. China’s initial reform policies resembled those of their Qing predecessors, confining foreign commerce to a few localities. But over time, Chinese reform deepened, leading to the gradual dismantling of the fundamental institutional structure of the planned economy. The prolonged era of peace and order in the last few decades – a sharp contrast China’s Republican era during the first half of
the 20th century marked by two world wars and Japanese aggression – provided time and space for gradual reform. The peaceful and prosperous rise of Japan and East Asian tigers offered powerful models of export-oriented economies. As a result, several decades of gradual reform have moved China from extreme isolation to the opposite extreme, achieving trade ratios that dwarf those of other major economies, absorbing large flows of foreign investment, and, most recently, emerging as a substantial originator of outbound foreign direct investment.

6.3 Unfinished business, uncertain prospects

This essay offers a comprehensive re-evaluation of the historical origin of China’s economic transformation. Our objective is to provide a single analytic framework that can explain China’s long-delayed response to the threats and opportunities arising from the British industrial revolution as well as the unprecedented speed and scale of the growth spurt that began in the late 1970s and continues today. Our analysis highlights ideology and institutions as crucial obstacles that constrained China’s economy throughout the 19th century and into the early decades of the 20th century. We emphasize gradual changes in ideology and institutions that relaxed key constraints and thereby contributed to modest economic gains during the decades prior to World War II, and then supported the more robust economic advance under the planned economy regime from 1949 to the late 1970s. We attribute the genesis of China’s current boom to the simultaneous erosion of both Qing-era constraints and new obstacles imposed under the PRC’s planned economy.

Widespread agreement about both the strengths and weaknesses of the present system conceals divergent expectations about China’s economic prospects. Assuming domestic political stability and continued access to overseas markets, Perkins and Rawski (2008) anticipate that China can maintain real annual growth in the 6-8 percent range to 2025. Others question the assumption of political stability. Citing evidence of

86 Official data for 2007-2010 show annual trade ratios of 62.7, 57.3, 44.2, and 50.3 percent (Yearbook 2010, pp. 38, 229; information for 2010 from China Data Online).

87 In 2009, China’s outbound overseas direct investment reached $59 billion (world rank #5 in 2008), while its incoming FDI (world rank #2, following the United States) amounted to $105.7 billion; see http://www.chinadaily.com.cn/bizchina/2011-03/23/content_12213110.htm, accessed April 12, 2011.
corruption, predation, and rent seeking, Minxin Pei argues “the economic costs of ensuring the CCP’s political monopoly … though hidden, are real, substantial, and growing …” leading to “a set of self-destructive dynamics” that endanger China’s “most vital political institutions” (2006, p. 206).

Pei’s concerns point to long-standing institutional constraints that the PRC has not addressed. The fundamental issue is the absence of checks and balances on China’s rulers. Neither the Qing emperors nor their contemporary successors face any form of external accountability that, in other systems, might come from legislatures, courts, or elections. During the Qing era, we argue that the logic of unconstrained power led to incomplete property rights. This, in turn, promoted networks of patronage in which property owners sought protection by forming alliances with politically powerful individuals and groups, who provided shelter in exchange for cooperation and financial benefits.

While the abuses cited by Pei and others partly reflect what Andrei Schleifer and Robert Vishny (1998) call the “grabbing hand,” there is a larger pattern of systematic effort that acts to secure and redistribute resources in order to preserve and increase cohesion within the ruling groups, its associates and its supporters. In China, the institutional structures surrounding the financing, approval, and execution of investment represents the chief vehicle for such activity.

Access to investment opportunities, credit, and land are routinely used to buttress the current regime and its allies. Official approval (pizhun), an essential step in business formation and expansion, may be reserved for well-connected insiders, especially in sectors promising high profits. China’s state-owned banks specialize in lending to favored clients, particularly state-owned enterprises, at below-market rates and with lenient repayment provisions. Allocation of land is similarly tilted in favor of official associates and clients.

Although this system is not without advantages – as when China’s government, by ordering state-owned banks to dispense massive loans, achieved the V-shaped recovery that has eluded the U.S. economy following the 2008 financial crisis, the cost of such arrangements, although difficult to specify, is surely high. India’s economy, which is no paragon of efficiency, approaches China’s overall growth rates despite
investing a considerably smaller fraction of GDP. Pouring cheap credit into the state sector increases financial risk, fuels outsized seasonal fluctuations, elevates capital intensity, contributes to sluggish job creation, and aggravates long-standing unemployment problems (Thomas Rawski 2002). As in imperial times, the patronage economy is much in evidence: relatives and associates of top leaders can readily parlay their personal connections into prominent and lucrative positions in the business world; private entrepreneurs must arrange informal security umbrellas to deflect arbitrary disruption of business operations.88

Thus far, the momentum of China’s long boom, now well into its fourth decade, has pushed aside these costs and other seemingly daunting obstacles.89 External events, especially the advance of globalization, with the attendant expansion of overseas markets, international supply chains and transnational flows of capital and technology, have provided enormous benefits. Most important, perhaps, is the robust development of China’s non-state economy, which has provided sufficient resources to sustain rapid growth despite the drain associated with the distortions, graft, and rent-seeking that bedevil the public sector.

Once again, costs and pressures may be on the rise within China’s political economy. There are signs of decreasing government effectiveness. Economic rebalancing and management of corruption represent areas where the state has failed to attain its own widely advertised objectives. The lack of independence in the legal system adds to the widespread sense of social injustice resulting from corruption and inequality.

Although Beijing has vowed to lessen the economy’s dependence on exports and investment since the late 1990s, the GDP share of fixed investment, already at levels that no other economy has matched, continues to rise, in part because China’s distorted financial system contributes to high personal and business savings, which in turn facilitate further growth of investment.

88 A typical description notes that “the price that private entrepreneurs had to pay to ensure political protection was in the form of de facto extortion on the part of cadres” (Kellee Tsai 2002, p. 128).
89 The costs have also been lightened by China’s exceptional high savings, which is nearly half of GDP, and the exceptionally high productivity outside the state sector.
Repeated announcements of anti-corruption drives have produced no visible results: China’s score in Transparency International’s corruption perceptions index is the same in 2010 as in 2001, as is its relative position: better than India or Russia, worse than Turkey or Brazil.

In both instances, policy failure may arise from a clash between publicly stated objectives and the inner workings of China’s patronage economy. Recent infrastructure failures, including the July 2011 collision involving two of China’s vaunted high-speed trains, highlight the system costs associated with sectors that combine massive investment with large-scale corruption.

Equally striking is growing evidence of rising pressure affecting highly successful participants in China’s patronage economy, many of whom are now considering overseas migration. “You can feel the anxiety of the ultra-wealthy and even of the political elite. They feel there’s no security for their wealth or possessions, and that their assets could be taken away at any time. Nobody feels protected against the system anymore.”

These observations raise two sets of questions:

Can the current institutional structure support continued rapid growth in the face of growing pressures as demographic change and rebalancing efforts lower household savings rates? As China’s rising wages erode long-standing comparative advantage in a growing range of labor-intensive industries? With continuing wage pressures as formerly “unlimited” supplies of migrant labor begin to dwindle? As China’s technological advances put an end to easy gains from absorbing imported equipment and manufacturing processes? As limited enforcement of intellectual property rights inflicts growing damage on innovative Chinese producers? If recession and protectionism slow the growth of world trade?

If continued growth requires another episode of major reform, is China’s current political equilibrium sufficiently flexible to withstand large-scale dissolution of rents that might accompany a steep reduction in the share of credit reserved for government

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90 Jamil Anderlini and Patti Waldmeir 2011, quoting an informant whom they describe as a “publishing and fashion mogul.”
projects and state-owned enterprises? Or a no-holds-barred effort to root out corruption such as Hong Kong accomplished during the 1970s (Melanie Manion 2004)?

Such concerns are not new. Writing the mid-1990s, two prominent China specialists expressed grave doubts about the system’s viability. Barry Naughton wrote that

The political system is simply not adequate to cope with the challenges that confront it. The dysfunctional political system might prevent the Chinese people from quickly building the kind of future system they would prefer; it might even jeopardize the achievements of recent decades (1995, p. 310).

Nicholas Lardy concluded his 1998 study by emphasizing the long-run importance of

“restructuring the banking system … [even though this] will require the state and the party to surrender a great deal of economic and political power … [in order to avoid] a lower pace of economic growth, a declining rate of job creation, and thus an even greater challenge to political stability.” (pp. 221-222).

The ensuing 15 years of continued economic advance even in the face of two major global shocks demonstrate the risk of predicting the trajectory of China’s complex political economy.

Careful historical study must figure prominently in serious efforts to grapple with these and many other questions surrounding the political economy of contemporary China. This review reveals powerful complementarities between efforts to fathom the structures and mechanisms undergirding China’s recent economic advance and studies that aim to expand our understanding of China’s imperial economy. Our survey demonstrates the insights that historical study can bring to the analysis of contemporary affairs. Several years of struggling to comprehend an immense body of historical scholarship has reinforced our conviction that contemporary developments can also provide fresh perspectives for addressing the vast and rapidly expanding storehouse of materials on the history of what once was and soon will become the world’s largest national economy.