6
Systemic Transformation: Neoliberalism Meets the China Paradox

6.1 China, globalization, and the transition doctrines

Against the background of disappointments in world development, China's sustained rapid economic growth in the era of globalization, over and above its respectable record in the previous decades, is not only phenomenal but also paradoxical. After all, China's economic institutions and development policies have long been dismissed by the orthodox establishment of the world – represented by the Washington establishment and its associated doctrines known as the Washington Consensus – as seriously deviating from the free market economy. They have been dismissed as no more than market-distorters and crisis-makers. The fact that the authorities of the European Union, Japan, and the United States of America have sternly refused to grant their recognition of the 'market economy' status to China testifies to this dismissive attitude.[1]

Is Chinese economic transformation really a paradox for the orthodox doctrines of globalization? In particular, does the experience fundamentally undermine the validity of the orthodox doctrines on systemic change and economic development? Attempts to interpret the Chinese experience in a way that is consistent with the so-called transition orthodoxy – also known as 'market fundamentalism in transition' (IMF 2000) or 'the transition doctrine of the Washington consensus' (Stiglitz 1999) – have coalesced around the following two propositions. First, *concerning institutions*, it is claimed that China's reformed economic institutions have been a mix of market-conforming and market-supplanting elements, that its developmental achievements have been ascribable to the conforming elements while the accumulated problems have been ascribable to the supplanting elements, and that

the problems have tended to outweigh the achievements as Chinese economic transformation proceeds from the allegedly easy phase to the difficult phase. Second, *concerning development*, it is claimed that differences in country-specific factors, most importantly the different levels of industrialization, have largely explained the contrast between China's sustained rapid growth and the depression in countries of the former Soviet bloc, and that this contrast is largely unrelated to differences in the strategies of systemic transformation.[2]

The main thrust of Proposition One is the principle of individualistic property rights. Ultimately, the so-called market-supplanting elements refer to widely observable institutional arrangements that violate the principles: discrete government intervention in economic affairs (the state–business relationship), soft budget constraints (the finance–industry relationship), and rigid employment and compensation systems (the worker–enterprise relationship). The negation of these arrangements is necessary for justifying the orthodox policy prescriptions of mass privatization, and of subjecting ownership to market trading via liberalization of the regimes of domestic and international finance. It is asserted time and again that, should the market-supplanting elements continue to exist, the future prospects for the Chinese economy are at best uncertain and more likely crisis-prone. The only way to avoid this looming crisis is to 'complete the transition to the market,' as speedily as possible.[3]

Leaving aside its detailed arguments, to be discussed in later sections, at the overall level Proposition One does not cope well with reality. Early on, Weitzman (1993, p. 549) observed: 'According to almost any version of standard mainstream property rights theory, what has been described as the "East European model" basically represents the correct approach to transformation, while what we are calling the "Chinese model" should represent a far-out recipe for economic disaster … The central paradox is the enormous success of the Chinese model in practice, contrasted with the sputtering, tentative, comparatively unsuccessful experience with the East European model.' Almost ten years later, in reviewing the persistent contrast between 'East Asian transition economies' (i.e. China and Vietnam) and transition economies in Europe and the Commonwealth of Independent States (i.e. countries of the former Soviet bloc), Fischer (2001) made a similar comment. The Chinese experience appears to indicate that adherence to the principles of individualistic property rights is neither necessary nor sufficient for avoiding economic disaster, indeed for generating sustained rapid economic growth.

Proposition Two is thus needed for the transition orthodoxy. The World Bank (1996, p. 5), in its first systematic report on the economics of transition, frames such a question for itself to answer: 'Do differences in transition policies and outcomes reflect different reform strategies, or do they reflect primarily country-specific factors such as history, the level of development, or, just as important, the impact of political changes taking place at the same time?' Proposition Two is the answer. Its implied message is that the transformation experiences of China and countries of the former Soviet bloc are not really comparable, but, insofar as there is a limited scope of comparability, the comparison tends to support rather than undermine the transition orthodoxy. Because of the incomparability, the World Bank (2002) simply excluded China in its second systematic report on the economics of transition. The IMF (2000) and the OECD (2005), meanwhile, still bothered to insist on the assertion concerning the implication of the limited scope of comparability. They endorsed what Sachs and Woo (1994) had argued early on: that, unlike countries of the former Soviet bloc, China was just fortunate to be at a low level of industrialization at the beginning of its reform – it has thus been able to generate economic growth via labour transfer from the rural-agricultural sector to industry, while postponing the needed, unavoidably painful reforms.

What underpins both of the two orthodox propositions is the belief that economic development, as dictated by the principles of the market – and the actual working of the world market – is somehow easy, natural, or normal. This is the notion of the 'natural path of development,' the ultimate promise of neoliberal globalization. But the notion is in no sense uncontroversial. Stiglitz (1999), at the time when he was chief economist of the World Bank, spent great efforts on trying to direct the orthodox establishment away from this belief. Regarding the economics of transition, he argued that China has faced a task of transformation that is far more difficult than that faced by countries of the former Soviet bloc. This is because China's task encompasses both systemic reform and economic development, rather than systemic reform alone. This judgement suggests that economic development is by no means a natural or easy process.

Stiglitz's judgement appears to fare far better with the reality than the transition orthodoxy. China's growth performance stands in contrast not only to countries of the former Soviet bloc but also to most parts of the developing world. The actual record of world development under globalization, as depicted earlier with reference to Table 1.1, has been dismal. Meanwhile, the initial condition of China's economic

transformation is not simply one of under-industrialization. In 1980, industrial value added accounted for an astonishingly high proportion (44%) of China's GDP. This is lower than the Soviet Union (54%), on a par with Brazil (44%), but higher than South Korea (40%) and India (24%) in the same year (data from World Bank, *World Development Report* 1982). The fact that, despite starting with one of the highest industry-to-GDP ratios in the world, China has been able to maintain very rapid industrial growth throughout the reform era, and with it to absorb labour transferred from the rural-agricultural sector, clearly should not be taken for granted.

6.2 The dynamics and conditions of transformational growth

China's economic transformation has been dominated by three discernible attributes. First, industrialization has been the immediate driving force of economic growth. Second, there was a switch in the early 1990s from labour-intensive growth to capital-deepening growth. Third, the growth path also switched from consumption-led to investment-led between the two halves of the reform era. The analysis of the dynamics and conditions of these three attributes is key to the understanding of the overall economic transformation.

The immediate dynamics behind Chinese economic growth is clearly a process of rapid industrialization. Between 1978 and 2007, the average annual growth rate of real GDP and per-worker real GDP was 9.8% and 7.5%, respectively. In the same period, the average annual real growth rate of industrial value-added and per-worker industrial value-added was 11.6% and 9.2%, respectively. Both the output and productivity growth rates of industry substantially exceed those of the economy as a whole, on average by almost two percentage points per annum. Figure 6.1 shows the evolution of labour productivity of Chinese industry relative to the rest of the economy, both in nominal and real terms. The curve representing relative labour productivity at constant prices has persistently exceeded that representing the indicator at current prices. This indicates a transfer of productivity gains in industry to the rest of the economy via changes in relative prices, thereby propelling overall economic growth. The fact that the gap between the two curves has tended to widen over time, moreover, implies that the pace of productivity transfer has tended to accelerate.

The transition from labour-intensive growth to capital-deepening growth is also clearly evident. As can be seen from the data in Table 6.1,

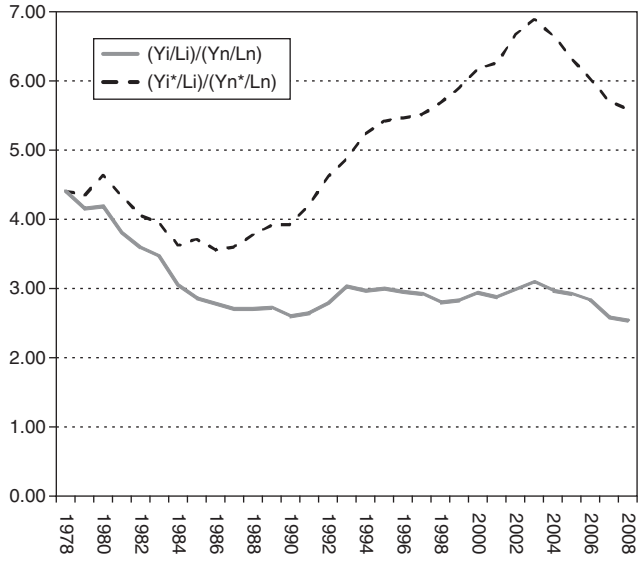

Figure 6.1 Relative labour productivity of industry in China

Sources: China National Bureau of Statistics, *China Statistical Yearbook*, various issues.
Notes: Y = GDP and its components at current prices, with * denoting data at 1978 constant prices. L = total labour employment. The subscripts *i* and *n* denote the secondary sector (i.e. industry plus construction) and the rest of the Chinese economy, respectively.

Table 6.1 Average annual growth rates (%) of real GDP, employment, and labour force

	(a) Real GDP	(b) Employment	(c) Labour force	(a)–(b)	(b)–(c)
1978–2007	9.82	2.27	2.30	7.55	−0.03
1978–92	9.39	3.63	3.60	5.76	0.03
1992–2007	10.16	1.02	1.10	9.15	−0.08

Sources: China National Bureau of Statistics, *China Statistical Yearbook 2008*.

between 1978 and 1992, economic growth, along with productivity improvement, was associated with fast growth in labour employment. The average annual growth rate of employment actually exceeded that of the labour force. Improvement in productivity has accelerated after 1992, by on average more than three percentage points per annum over the record of the previous period. But this has been achieved along

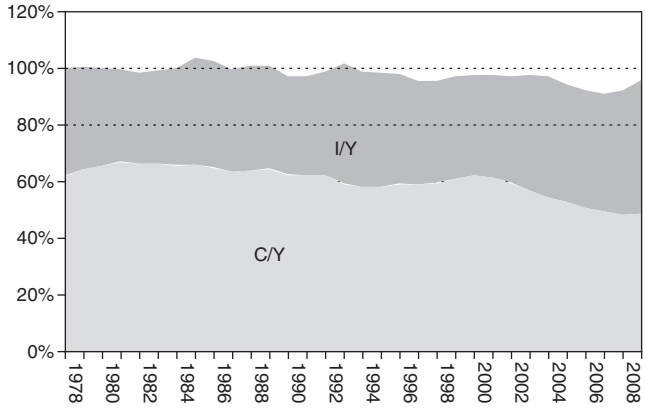

Figure 6.2 Composition of Chinese GDP by expenditures (%)

Sources: China National Bureau of Statistics, *China Statistical Yearbook*, various issues.
Note: C = final consumption; I = investment. Note that Y = C + I + NX, where Y is GDP by expenditures, and NX = net export of goods and services.

with the slowdown in employment growth. The growth of employment since then has slightly lagged behind that of the labour force.

The transition from consumption-led to investment-led growth is equally apparent. Figure 6.2 charts out the composition of Chinese GDP by expenditures. It can be seen that, of the aggregate expenditures, consumption accounted for a substantially bigger share in the first half of the reform era (1978–92) than in the second half (1993–2007), by on average more than ten percentage points. The opposite was true for the evolution of the share of aggregate expenditures accounted for by investment. It is only in recent years, since 2004, that the third component, net export, has accounted for a significant share of aggregate expenditures.

Accounting for these attributes of Chinese economic growth requires a theoretical perspective of transformational growth – that is, seeing growth as a process of change rather than simply as a process of expansion. Succinctly, the analysis needs to clarify the structural-institutional arrangements that underlie the growth process (the productivity regime), and the conditions that facilitate the working of these arrangements (the demand regime). It is the interaction between these two aspects that forms a particular economic growth path, such as those that prevailed in China in the two sub-periods of the reform era.

The orthodox notion of the 'natural path of development' is not helpful in this regard. It does possess a theory of growth as a process of change, in the form of the so-called stages approach to comparative advantage. The essential idea is that the optimal path of structural change of an economy will emerge automatically, if the international specialization of the economy follows its shifting (endowment-determined) comparative advantage over time. This theory is insufficient because, by taking a black-box view on production and assuming that the best practices of production are automatically accessible to all producers, it is of little help for clarifying the productivity regime. The theory could even be misleading, in the sense that it simply assumes away the need to clarify the demand regime – the world market, in particular, is assumed to provide whatever demand condition that is needed for economic growth.

The literature on transformational growth has been dominated by the work of Nicholas Kaldor, or the tradition associated with him. And there are good reasons for this, as the stylized facts of industry-led economic growth known as the 'Kaldor-Verdoorn Laws' are almost universally accepted by development economists. The essential idea of this tradition is that the interaction between the productivity regime and the demand regime, particularly within the manufacturing sector, is typically one of circular and cumulative causation. An industry-led growth path is thus necessarily a disequilibrating process that would not converge with a predictable steady state.[4] Kaldor himself, and the broader tradition of Post-Keynesian economics, do have well-developed theories on the determination of the composition and growth of aggregate demand. Yet for the study of a particular growth process in reality, the Post-Keynesian tradition might need to be complemented by further theories on the specific character of the productivity regime as well as the specific mechanism through which the productivity regime interacts with the demand regime. The Schumpeterian theory of innovation might be helpful for the former task, while the Marxian theory of capital accumulation might be helpful for the latter. This and the next sections seek to analyse China's economic transformation by drawing on these three theoretical traditions and contrasting them with the orthodox theory.[5]

Consider the economic growth path in the first half of the reform era, 1978–92. As indicated previously, this was a process of labour-intensive, industry- and consumption-led growth. The downward movement of the incremental capital–output ratio (ICOR) of the economy in this period, shown in Figure 6.3, suggests that there was a continuous process of substitution of labour for capital in production. The growth

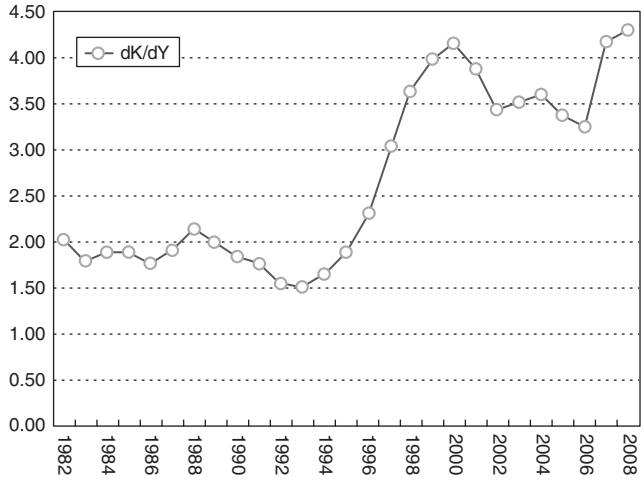

Figure 6.3 Incremental Capital-Output Ratio of the Chinese economy (five-year moving averages)

Sources: China National Bureau of Statistics, *China Statistical Abstract*, various issues.
Notes: Incremental Capital–Output Ratio = dK/dY, where dK = total fixed-asset investment, dY = GDP of current year minus GDP of last year.

process was associated with a massive transfer of labour from the rural-agricultural sector to industry, where the latter sector was characterized by a much higher productivity level and much faster productivity growth. Was this process simply a validation of the neoclassical theory of relative scarcities and, therefore, the orthodox notion of the 'natural path of development'? This question can be approached by examining both the prevailing productivity and demand regimes.

Insofar as the orthodox notion does explain the sources of productivity growth, it must be with serious qualifications. In the institutional dimension, as will be looked at in the next section, throughout the first half of the reform era the Chinese economy was almost entirely composed of public firms, that is, state-owned and collectively-owned enterprises. The orthodox notion envisages that the 'natural path of development' would occur in the context of a market economy, but it is not clear whether this judgement could remain valid if the economy is in fact dominated by public firms.

In the structural dimension, the sources of productivity growth were also far more complex than improvement in allocative efficiency alone, as envisaged by the orthodox notion. It can be argued that of equal

importance in accounting for the growth in productivity was improvement in productive efficiency, which was associated with the explosive growth of a wide range of mass-production, 'new' consumer durables.[6] These goods were mainly products of the broad machinery sector, that is, the mechanical and electronics industries. Thus, between 1978 and 1992, the share of gross output value of Chinese industry accounted for by the machinery sector registered a massive increase: from 26% to 27% if measured at current prices, and from 26% to 33% if measured at constant prices of the base year 1978.[7] In terms of technical and economic characteristics, the production of these goods was characterized by rapid technical change, extensive backward and forward linkages, and high income elasticities of demand. Yet the industries did not clearly accord with the principle of relative scarcities: it can be verified that, according to the customary criterion of relative labour productivity, the machinery sector in China during this period could not be classified as labour-intensive, while the electronics industry could only be classified as capital-intensive. In a significant measure, therefore, the direction of structural change in Chinese industry in the first half of the reform era appeared to contradict the expectations of the orthodox notion.[8]

Meanwhile, the demand regime also cannot be considered a trivial issue. Recall that China's rapid industrial growth has been achieved in the context of starting in the late 1970s with one of the highest industry-to-GDP ratios in the world. On the world scale during this period, a main factor that impeded late industrialization came precisely from demand-side constraints. There must exist some peculiarities in China in the first half of the reform era such that the accelerating pace of industrialization found its necessary demand conditions. The crux appeared to be the 'consumption revolution,' which was felt by the entire urban population: between 1981 and 1992, for example, the ownership per 100 households in urban China of colour television receivers increased from 0.59 to 74.87, that of washing machines increased from 6.31 to 83.41, and that of household refrigerators increased from 0.22 to 52.60. It was the existence of domestic mass consumption that sustained the explosive growth of the industries of mass-production, new consumer durables. Conversely, it can be argued that Chinese economic growth in this period was based on a nexus of causal relationships of the following form: consumption induced investment and overall demand expansion, thus making it possible to absorb transferred labour from agriculture and to improve industrial productivity via dynamic increasing returns. There seemed to exist a virtuous circle between consumption and production, and between industry and the economy.

The dynamics of Chinese economic growth in the 1978–92 period as characterized before presupposes the existence of two necessary conditions. First, the process of structural change involved both an expansion of the share of industry in the economy and the leading role of a wide range of mass-production industries. The former aspect corresponds to the trend of labour transfer from agriculture to industry, and hence improving allocative efficiency, while the latter aspect corresponds to the 'Kaldor-Verdoorn Laws' of improving industrial productivity via dynamics increasing returns. Second, there must exist an egalitarian pattern of income distribution which underpinned mass-consumption, thereby inducing investment and overall demand expansion. Income distribution covers the total of both money and non-money incomes for Chinese people, particularly for urban residents in the first half of the reform era. The degree of egalitarianism is thus difficult to gauge by conventional measures of income distribution such as the Gini index. Perhaps a more appropriate measure would be the indicator of life expectancy at birth, which in some ways reflects the combined effect of all indicators of social development. It is well-known that, on this measure, China's performance in the late 1970s was very close to the average of all middle-income economies in the world, even though it was a low-income economy. By the early years of the twenty-first century, China's performance on this indicator remained very close to the average of all middle-income economies, despite the fact that its economic growth in the preceding two decades had far outstripped the rest of the developing world. It seems reasonable to argue that a social development performance that substantially exceeds the average of economies of comparable income levels must be due to a higher-than-average degree of egalitarianism in income distribution. On this basis, it seems appropriate to assert that, for the main part of the reform era, China's pattern of income distribution tended to be egalitarian by international standards – although it is also true that egalitarianism tended to wither along with market reforms.[9]

Turning to the economic growth path in the second half of the reform era, 1993–2007, its capital-deepening nature is most clearly indicated by the upward movement of the ICOR during this period. This direction of change appears to violate the principle of relative scarcities – particularly in view of the fact that, as indicated previously with reference to Table 6.1, employment growth has tended to lag behind that of the labour force. The growth process has actually been associated with the further, and continually fast, expansion of the machinery sector: by 2007, its share in the gross output value of Chinese industry as a whole remained at 26% if measured at current prices, but increased to 40% if measured at constant

prices of the base year 1978. Just as happened pre-1993, the machinery sector has continued to play a leading role in Chinese industrialization, both in terms of its faster pace of growth and the transfer of its productivity gains to the rest of Chinese industry via changes in relative prices. It appears that the driving force behind Chinese economic growth post-1993, which has been associated with a pace of productivity growth that is much faster than the previous period (see Table 6.1), has been an improvement in productive efficiency alone. The capital-deepening growth path, while deviating fundamentally from the 'natural path of development,' has actually been impressively efficient.

But the demand regime has changed, evident in the decreasing share of consumption in aggregate expenditures. The explanation of the sluggish growth of consumption in China is complex and controversial, but one point seems clear: it has been in a significant measure due to the continuous worsening of income distribution. Although not an adequate measure, the Gini index does broadly indicate this worsening trend. In 1978, the value of the Gini index in China was 0.16 for urban households and 0.21 for rural households, both being rather low in international comparison. By 1992, the value increased to a moderate level of 0.25 for urban households and a high level of 0.31 for rural households. By the year 2000, the value rose to high levels for both set of households: 0.32 urban, 0.35 rural (Li Shi et al. 2000; *Renmin Ribao* [People's Daily] 9 July 2002). In this context, the change in output-mix associated with the expansion of the machinery sector has no longer been mainly based on the growth of consumer durables. In line with the rising ICOR in production, Chinese economic growth since the early 1990s has tended to follow what is known in the literature as the Feldman-Mahalanobis model – that is, a growth path that is based on 'producing investment goods for producing investment goods.' Conceptually, can such a growth path be efficient, and sustainable?

In the theoretical literature, and especially in the tradition of Marxian economics, the justification for the Feldman-Mahalanobis model is that the machinery sector is particularly responsible for the generation and diffusion of technological change. The development of the sector is considered to be necessary for promoting dynamic increasing returns, and hence productivity growth, in the economy as a whole. The sources of increasing returns, as emphasized by the Kaldorian theory of circular and cumulative causation, are the interaction between the appropriate productivity and demand regimes. These take the form of learning by doing, induced investment for technological upgrading, and the deepening of the division of labour in the economy – in short, the effects

of '(productivity-improving) innovative activities'. The contribution of the Schumpeterian theory of innovation, in this connection, is its focus on the capability of the institutions involved in generating innovative activities. Specifically, institutional attributes that are consistent with the innovative activities of these three forms entail the requirement of rigidities, that is, long-term-oriented relationships among major stakeholders of the business system. Such attributes are antithetical to the logic of allocative efficiency, which requires flexibilities, particularly the free movements of finance in its profit pursuits. There thus exists a trade-off between the required institutions for productive efficiency and those for allocative efficiency. This argument underpins an insightful framework for analysing the institutional attributes of China's productivity regimes, which will be carried out in the next section.

What about the sustainability of the post-1993 economic growth path? Conceptually, in both Marxian and Post-Keynesian economics, demand expansion is normally determined by two sets of factors, exogenous and endogenous. Exogenous factors refer to the pattern of income distribution and of consumption, and the history-specific political and cultural conditions that underpin these patterns. Endogenous factors refer to the specificity of the economic growth path in question. For a growth path based on 'producing investment goods for producing investment goods,' Marxian economics suggests that its sustainability on the demand side hinges on the pace of product innovations. It is through product innovations that the variety of investment goods could continuously expand, and that the law of diminishing demand for the output-mix would not set in.[10] The sources and pace of product innovations in Chinese economic growth, particularly in the post-1993 period, are an important issue demanding scholarly study. Nevertheless, one point seems clear: in addition to domestic generation, an important source of product innovations is from continuous, large scale importing of foreign technology. This is a continuation, but on a much larger scale, of the situation in the first half of the reform era, where the expansion of the industries of new consumer durables (which were new to China) required the import and assimilation of foreign technology.

6.3 The efficiency attributes of market-supplanting institutions

The logical starting point in the nexus of causal relationships underpinning Chinese economic growth in the first half of the reform era, as depicted in the preceding section, was the existence of an egalitarian

pattern of income distribution. This pattern was, in turn, based on China's specific political economy. For a major part of the reform era, but especially in the first half, the economy was dominated by public ownership, and within the publicly-owned sector egalitarianism in distribution was the norm. In 1992, state-owned enterprises (SOEs) and collectively-owned enterprises combined to account for 86% of the output of Chinese industry as a whole. By the turn of the century, the share still remained at 64%, with the rest being accounted for by the catch-all category of enterprises of 'other ownership types,' which include private firms and various types of joint-ownership firms. Even for shareholding firms that are not formally state-controlled, a significant proportion (mainly those listed on the stock market) actually has state agents as the ultimate owner-controller.

It is thus possible to turn back to view the orthodox establishment's Proposition One on China, concerning the nature and attributes of its reformed economic institutions, in a different light. What it considers as market-supplanting elements of the Chinese economy are precisely the egalitarian systemic features, particularly those of SOEs. The observation is widely agreed upon: that the institutions of SOEs have significantly deviated from principles of the market economy, notably individualistic property rights. Conceptually, in the relevant literature, China's enterprise reform has generally been portrayed as a process of the state attempting to induce entrepreneurial activities by management. But this process has occurred in a broader context where various stakeholders of enterprises – local governments, workers, local communities, the banks, and other business partners – have been involved in forming a web of checks and balances governing the operation and development of enterprises. This systemic feature is visible not only in SOEs but also in enterprises of other types of public ownership, including the renowned township and village enterprises (TVEs), which were mostly collectively-owned until the early 2000s.[11]

The crucial question, however, is: what are the developmental implications of this rigidity-infused, long-term-oriented systemic feature of Chinese public firms? It was alluded to, in the beginning of this section, that this feature has the advantage of underpinning the egalitarian pattern of income distribution and therefore mass consumption. But has it also resulted in gross inefficiency of enterprises at the micro level – as the orthodox establishment has persistently maintained?

The assertion about China's allegedly ailing state sector has been so popular in the media that it seems trivial to answer this question. But in the scholarly rather than journalistic literature, the assertion has in

fact been a matter of debate. This debate first centres on the assessment of the change of productivity of SOEs in the reform era. Because of the very different estimation results of total factor productivity growth in SOEs obtained by large number of different studies, and because an objective criterion is lacking by which to resolve the difference, the orthodox assertion has been far from the dominant view on the matter. Even the World Bank (1996, p. 23) has had to adopt a concessive tone, stating: '(China's state sector) remains a drag on the economy during the reform era – even though its efficiency may be improving.' Hence, and in connection with the 1997–8 East Asian financial crisis, the orthodox establishment has shifted the basis of its assertion to the financial performance of SOEs. It is claimed that the trend of declining enterprise profitability, together with the rising ratio of non-performing loans of state banks, are symptoms of the same ill: the gross inefficiency of SOEs. It is further claimed that this must be treated as a matter of urgency, as otherwise an East Asian-type crisis is most likely to occur in China.[12]

Compared with the orthodox Proposition Two (on development) dissected in Section 6.2, this Proposition One (on institutions) does not fare better in reality. At one level, it is a gross exaggeration to assert that the nexus of SOEs, state banks, and the state itself as a whole has always been on the verge of a financial collapse. The fact that the Chinese economy performed well during and after the 1997–8 East Asian crisis flies in the face of this assertion. To the extent that the nexus has indeed accumulated financial problems, this is largely a result of the fiscal difficulty of the state rather than enterprise inefficiency, for, over the reform era, SOEs have paid many social costs that should have been the responsibility of state finance. They have paid income taxes at much higher rates than other enterprises, while also facing serious under-capitalization from the state-owner. At another level, the observed decline of enterprise profitability reflects more a macroeconomic issue than microeconomic inefficiency. As can be seen from Figure 6.4, the pre-tax profit rate of SOEs has in fact been very close to the average of all enterprises: slightly higher in the 1980s and slightly lower in the 1990s, while exhibiting both a tendency of secular decline up until 1998, and of substantial rebound post-1998. Noting that China's accounting system has tended to underestimate depreciation, and hence to overestimate the capital stock of SOEs, which are in general much older than non-SOEs, it could be argued that the profit rate of SOEs is likely to have been higher than the industrial average in most years of the reform era.[13]

Figure 6.4 also shows that, throughout the reform era, the pre-tax profit rate of large-scale enterprises has been higher than the industrial average. It can be verified that the same applies to the comparison of other performance indicators, such as output and productivity growth. Given that the vast majority of large-scale enterprises are in fact SOEs – they have formed the core of China's state sector – it appears that the orthodox Proposition One cannot be further from reality. What is more reasonable, therefore, is to see how this seemingly paradoxical reality could be made sense of. What kind of advantage can be generated by the systemic feature of SOEs, which appears to have more than compensated for the (allocative) efficiency loss that is deemed unavoidable from the standpoint of orthodox economic theory?

It has been noted that the reformed Chinese enterprise system has been infused with rigidities, especially with an emphasis on maintaining a long-term relationship with major stakeholders. This is akin to the canonical East Asian, or Japanese, system, and there are well-developed theories to explain the economic advantage and disadvantage of

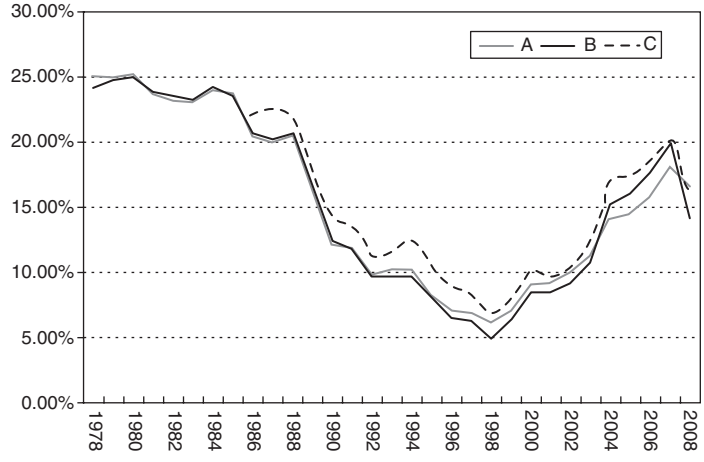

Figure 6.4 Pre-tax profit rates of Chinese industrial enterprises

Sources: China National Bureau of Statistics, *China Statistical Yearbook* and *China Statistical Abstract*, various issues.
Notes: A = All industrial enterprises (i.e. township-and-above independently accounting industrial enterprises for 1997 and before, and all state-owned plus above-scale non-state-owned industrial enterprises from 1998). B = state-owned industrial enterprises (including state-controlled industrial enterprises from 1996). C = large-scale industrial enterprises (data before and after 2003 are not fully comparable because of changes in statistical coverage).

systemic features of this kind. Succinctly, in the context of steadily growing market demand, industrial firms that are infused with rigidities and long-term orientation are especially capable of improving productivity via various kinds of dynamic efficiency, particularly through collective learning. In contrast, in the context of stagnant or contracting demand, firms of this kind have difficulty in adjusting and hence tend to be out-competed by flexible, market-conforming, and short-term-oriented firms (see Chapter 4 for a review of the theories).

The previous theoretical argument appears to be reasonable for explaining the fact that, in terms of industrial profitability, China's SOEs out-competed non-SOEs in the demand-expanding 1980s (and again in 2004–7), but were out-competed in the demand-stagnant 1990s (Figure 6.4). Conversely, such an explanation also pushes to the forefront the most prominent feature of the Chinese 'model' of economic transformation especially in the first half of the reform era. This, namely, is the essentially appropriate match between mass consumption at the macro level and the long-term-oriented behaviour of enterprises at the micro level, and, behind this, that between the egalitarian income distribution and the systemic feature of enterprises being accountable to major stakeholders. The significance of this match is no less than sustained rapid economic growth itself. It offers the opportunity for China to embark on a path of late development that takes a strong socialist character. But there are also constraints on such a pattern of economic transformation. The introduction of market practices might be necessary for micro-level incentives of economic development, but market reforms in the strict sense – that is, in applying principles of individualistic property rights – are bound to disrupt the indicated match between the macro environment and the micro institutions. On the macro side, such reforms tend to reduce workers' income and threaten their job security, thereby undermining egalitarian income distribution and mass consumption. On the micro side, such reforms tend to threaten the loyalty or long-term commitment of major stakeholders (again, workers in particular) to the firm, thus undermining the scope for productivity-improving innovative activities.

The 1995–7 downsizing drive in state firms is crucial in this regard. Initiated by the state leadership with an objective of corporatizing large and medium SOEs, and transforming small SOEs into shareholding cooperatives, the drive was seized upon by local governments simply to sell off state assets while unilaterally defecting on the state's obligation to the job security of workers (and passing the liabilities of the sold enterprises onto state banks and ultimately to the central government).

The crux of the matter is that, in the context of the demand-stagnant 1990s, SOEs had difficulty in utilizing the relative efficiency attributes of their rigidity-infused, long-term-oriented institutions to generate dynamic increasing returns. They were ill-equipped for competing with the more market-oriented private and collective firms, as well as the Western transnational corporations that began to enter China on a massive scale from the early 1990s onwards. The downsizing drive launched by local governments, in the form of mass lay-offs, further worsened the situation.

Consequently, unemployment surged, consumption expansion slowed down further, and investment growth also stagnated. Together with the worsening external environment caused by the East Asian crisis, all these plunged China into serious difficulties in the closing years of the century. A state of deflation persisted at the macro level. At the micro level, worsening financial performance of industrial enterprises and state banks was the norm. It was only with a significant policy reversal that economic growth was sustained in the crisis-prone period of 1998–2002. This policy reversal took the form of the state leadership shifting from the stance of pushing forward the marketization drive to forcefully implementing a range of market-supplanting policies. These policies included Keynesian-type fiscal stimuli, welfare-state measures, policies to revitalize SOEs and state banks, and a cautious approach to a further liberalization of the regime of external finance.[14]

The policy reversal in 1998–2002 did not result in the resumption of the previous pattern of economic transformation, however. What has emerged is a new pattern that exhibits a strong resemblance to the canonical East Asian model of economic institutions and growth. At one level, the path of industrialization characterized by capital deepening has become firmly established, with its pace tending to accelerate. This is largely due to the fact that consumption expansion has continued to be sluggish, and its leading role has been taken over by investment – hence the characteristic of 'producing investment goods for producing investment goods.' At another level, consistent with capital deepening and economic growth based on increasing returns is the rapid expansion of large-scale enterprises: their value-added share in Chinese industry as a whole increased from 27% in 1998 to 36% in 2002. This is ironic, as it occurred in a period when, on the world scale and particularly from the orthodox establishment, there was widespread criticism of the East Asian model of capital-deepening industrialization carried out by large-scale business conglomerates – the model dismissively termed as 'crony capitalism'.

This new pattern of economic transformation is clearly different from that of the first half of the reform era. There is no trace of an appropriate match between egalitarian income distribution and a systemic feature of enterprises being accountable to major stakeholders. True that, along with capital deepening and the indicated policy reversal, there has seen a phenomenal revival of the state sector. The value-added share of SOEs in Chinese industry increased from 33% in 1998 to 34% in 2002, and further to 36% in 2007, amid the rebound of their profit rate to surpass once again the industrial average. Yet, in an institutional sense, this revival has been more than outweighed by the massive decrease in the employment share of SOEs in Chinese industry: from 38% in 1998 to 15% in 2007. And this reflects the broader trend of the shrinking employment share of the public sector in the Chinese society as a whole. Of the total of urban employment, the combined share of state-owned and collectively-owned units decreased from 76% in 1995 to 41% in 2000, and down further to 24% in 2007. In the rural areas, the employment share of township and village enterprises has continued to grow (though at a substantially slower pace than of the first half of the reform era), but these enterprises have mostly been transformed from collective ownership to private ownership. Surely a society in which the main part of labour employment is with the private sector is very remote from socialist goals.

6.4 Dependence, inter-dependence, and dependent development

The previous discussion focuses on the internal dynamics of China's economic transformation. It is necessary also to discuss the importance of the external dynamics, that is, the role of foreign trade and foreign direct investment, for much importance has been attached to this in the existing literature. A popular story from the application of the notion of the 'natural path of development' states that Chinese economic growth throughout the reform era has followed a path of labour-intensive, export-oriented industrialization based on its endowment-determined comparative advantage. If it is further posited that the export sector is precisely China's market-conforming sector, then, once again, the two orthodox propositions described earlier in seem to be preserved. This completes the story of a market-determined, natural-cum-desirable development experience.[15]

Has China been mainly exporting labour-intensive products? Answering this question is crucial to the assessment of the orthodox

story. This need not require a comprehensive study of the evolution of the composition of Chinese exports. One counter-indicator might suffice: in 2007, mechanical and electronic products accounted for 61% of the total of China's manufacturing exports (and electronic products alone accounted for 40%). As indicated earlier, relative to Chinese industry as a whole, the machinery sector cannot be classified as labour-intensive, while the electronics industry can only be classified as capital-intensive. A further, related indicator concerns the proportion of high-tech products in manufacturing exports. In 2007, the ratio was 30% for China, which is much higher than Brazil (12%), Russia (7%) and the average of all middle-income economies (19%), and is close to that of South Korea (33%). Compared to China, these economies have much higher levels of per capita income, and hence lower degrees of 'labour abundance' or 'capital shortage'. It is thus seriously flawed to explain the expansion of Chinese exports in terms of its 'given' comparative advantage.

Has Chinese economic growth been mainly based on improvement in allocative efficiency realized via the external dynamics? As depicted earlier, the growth process has in fact been mainly based on the improvement in productive efficiency, particularly since the early 1990s. In this connection, the contribution of the external sector has been mainly in terms of technology import, which was essential for sustaining the path of economic growth in both the first and second halves of the reform era. It is this contribution – coming at a high costs, however – which suggests that increased openness or integration into the world market is, after all, a necessary condition for successful late development. Even so, the Chinese experience indicates that this contribution of the external sector is nothing automatic or natural. It rather requires the existence of the particular internal dynamics of economic development for the contribution to materialize.[16]

Has Chinese economic growth been export-dependent, at the level of aggregate demand? An affirmative answer to this question would imply that the sustainability of economic growth hinges on a comparable pace of export expansion – or even hinges on continuously increasing the ratio of trade surplus to the national output. But this judgement is contrary to the reality. As can be seen from Figure 6.2, trade surplus as a share of aggregate demand has not been really large in the long term. It is only since 2004 that the share has become large by international comparison, reaching the peak level of almost 10% in the year 2007. In the ten years or so before 2004, the share did not exceed 3% most of the time. And trade deficit was pre-dominant even earlier, in most years

of the first half of the reform era, that is, 1978–92. On the whole, it is reasonable to judge that export dependence is not really a structural feature of the Chinese economy.

Zhu and Kotz (2010) argue that the gross measure of net export might significantly understate China's export dependence because some of the imports are destined for domestic consumption.[17] This argument might contain elements of truth. Yet it has to be balanced by a perhaps even more significant counter force. This, namely, is the fact that China's trade surplus has been mainly accounted for by processing trade. Indeed, as can be seen from Table 6.2, for most years since the early 1990s surplus in processing trade has even exceeded the total surplus of China's foreign trade. And the contribution of processing trade to the Chinese economy has been modest. A rough estimate can be computed by assuming that the domestic value-added ratio of processing trade is equal to the ratio of net-to-gross export. This ratio is 45% at its peak in the year 2009, and the value-added so computed is only 5% of GDP in that year, which is hardly compatible with the proposition of trade dependence. What seems more reasonable to infer from

Table 6.2 China's total foreign trade and processing trade (US$ 100 million)

	X	PX	PX/X	M	PM	PM/M	(X–M)–(PX–PM)	(PX–PM)/PX
1992	849	396	47%	806	315	39%	−37	20%
1993	917	443	48%	1040	364	35%	−201	18%
1994	1210	570	47%	1156	476	41%	−40	17%
1995	1488	737	50%	1321	584	44%	14	21%
1996	1511	843	56%	1388	623	45%	−98	26%
1997	1828	996	54%	1424	702	49%	110	30%
1998	1837	1045	57%	1402	686	49%	76	34%
1999	1949	1109	57%	1657	736	44%	−81	34%
2000	2492	1377	55%	2251	926	41%	−210	33%
2001	2661	1474	55%	2436	940	39%	−309	36%
2002	3256	1799	55%	2952	1222	41%	−273	32%
2003	4382	2419	55%	4128	1629	39%	−535	33%
2004	5933	3280	55%	5612	2217	40%	−742	32%
2005	7620	4165	55%	6600	2740	42%	−405	34%
2006	9689	5104	53%	7915	3215	41%	−114	37%
2007	12178	6176	51%	9560	3685	39%	127	40%
2008	14307	6752	47%	11326	3784	33%	14	44%
2009	12017	5870	49%	10056	3223	32%	−686	45%

Sources: China National Bureau of Statistics, *China Statistical Yearbook*, various issues; *China Statistical Abstract* 2010; *Statistical Communique of Social and Economic Development* 2009.
Notes: X = total export, PX = processing export, M = total import, PM = processing import.

this observation is that the Chinese economy is in fact of a dualistic structure. The sector of processing trade is no more than an enclave, and is not really large enough to lead to export dependence for the Chinese economy as a whole.

Finally, it is necessary to address the further, and most fundamental, question of whether China's seemingly miraculous performance of economic growth in the second half of the reform era – the period of 1993–2007, when China became a major player in the world in expanding foreign trade and absorbing inward direct investment – has been mainly based on low labour cost. This question is of widespread concern, and the general perception tends to give an answer of 'yes'. Critical scholars, like neoliberal protagonists in terms of analysis but not assessment, have mostly placed 'super-exploitation' of labour at the centre of their interpretation of the Chinese experience as a process of neoliberal transformation. This fits well with their belief that neoliberalization can never deliver real economic and social development, despite outstanding growth performance.

Phenomena of super-exploitation have been widespread in China, particularly in the labour-intensive, export-oriented industries associated with inward foreign direct investment. But Chinese economic growth cannot be said to be based on super-exploitation. It is easily observable that throughout the reform era, and especially since the early 1990s, labour productivity growth in the Chinese economy has been extremely fast. As can be seen from Figure 6.5, in the period 1992–2009 the index of real GDP increased from 100 to 528, while that of labour employment (in terms of the number of employees) only increased to 118. Conceptually, labour productivity growth can be based on increases in work intensity as well as technological progress. And the waves of enterprise downsizing and mass privatization in the period 1993–7 probably did lead to substantial increases in work intensity. Yet it is difficult to conceive a trend of persistently increasing work intensity over such a prolonged period, particularly in the labour-intensive, export-oriented industries, which already had a high intensity of work in the early 1990s. It is most unlikely that a magnitude of productivity growth such as that shown in Figure 6.5 could mainly be attributed to increases in work intensity. Conversely, phenomena of super-exploitation that exist in China are mainly an issue of social fairness and justice, rather than the foundation and sustainability of economic growth. The fast productivity growth indicated in Figure 6.5 actually suggests that there is a solid material foundation for largely improving social fairness and justice – it implies that largely increasing labour protection and compensation is feasible.

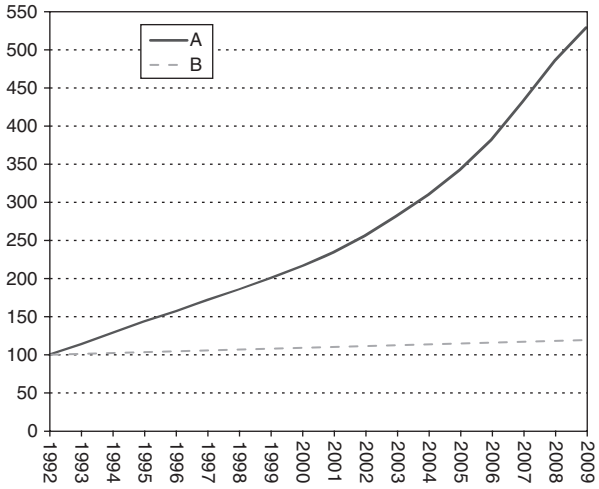

Figure 6.5 Indices of China's real GDP and labour employment (1992 = 100)

Sources: China National Bureau of Statistics, *China Statistical Yearbook*, various issues; *China Statistical Abstract* 2010.
Notes: A = real GDP, B = labour employment (year-end number of employees).

The previous exposition suggests that China's economic development over the reform era cannot be reduced to the notion of labour-intensive, export-oriented industrialization. It is not a validation of the neoliberal doctrines of globalization. Meanwhile, the exposition also suggests that China's connection with the capitalist world economy cannot be judged to be one of structural dependence. The crux of the matter is fast productivity growth. This indicates a high degree of independence, or autonomy, of Chinese economic development. Given the importance of China in world trade and in attracting foreign direct investment, fast productivity growth on the domestic front might even imply the dependence of the capitalist world economy on China. Thus, insofar as there is indeed some degree of structural dependence, it is likely to be bi-directional rather than uni-directional.

6.5 Summaries and Conclusions

China's sustained rapid economic growth in the post-1978 reform era, which is also the era of neoliberal globalization, is of worldwide importance. This growth experience has been mainly based on China's internal dynamics. In the first half of the era, economic growth was

driven by improvements in both allocative efficiency and productive efficiency. From the early 1990s until the present time, however, economic growth has been increasingly based on dynamic increasing returns associated with a growth path that is characterized by capital deepening. In both periods, the growth paths and their associated institutional frameworks appear to contradict principles of the free market economy – the mainstream doctrines of globalization.