Towards High Growth Economies:
Transformational Lessons from China (and other countries)

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1. Introduction

In 2008 China marked the 30th anniversary of its reform and opening up. By any standard China has done remarkably well. The 30-year reform period presents a remarkable study of progress of the largest developing country in the world. Not only has been growth been rapid – some 9 percent per annum in GDP per capita since 1979/80, but this growth has been accompanied by dramatic improvements in the lives of people. The Chinese people are wealthier, better educated and healthier than they have ever been.

A striking feature of Chinese reforms has been their 'non-conformist' nature. Many economists have long considered that countries cannot easily develop without well established laws of commerce, private ownership and functioning markets. This thinking has had a dominant influence on development economics and on development policies, leading to an unfortunate simplification of the complex processes at work as countries grow and develop. Further, this thinking has contributed to a premise that development is intrinsically a technical problem requiring technical solutions-such as increasing the capital stock, better resource allocation and preventing market failure (Stiglitz, 1998).

On the Chinese growth phenomenon, even after more than 30 years of reform, there is a continuing debate among economists about its key determinants. Some admire China's success and consider that many of the lessons are 'transportable', others essentially conclude that the growth is a bubble waiting to be pricked, even if the country managed to ride fairly well the current global financial crises that have engulfed the US and Europe, and yet others consider that China's experience is no different from other fast growing countries in East Asia like South Korea and Japan, thereby raising interest in looking at this group together for lessons learning for other developing countries (Malik, 2010).

This paper considers the Chinese experience an important example of sustained growth and development, with has many useful lessons for other countries. The paper focuses on 'transformational lessons'. As countries aspire to move from one level of development to the next, societies are changing as well, which in turn influences future development outcomes. With rapid change and transformation, the basic production conditions are themselves in play. Indeed, this is the very nature of development. By extension this means that the 'stage' of development the country finds itself has some bearing on the options for future development and the policies and reforms that are likely to succeed. The comparative strengths of countries themselves in turn are likely to vary with time and development.

From this perspective, the analysis of development must of necessity be extended to include what may be called complex and 'soft' factors such as leadership and vision, norms and values, rules and institutions, trust and cohesion, all that influence the organization of society, and their interplay with specific development policies and reforms. And, crucially, how the processes of transformation can come together under the right

[1] This paper draws extensively on a forthcoming book by the author, *Why Has China Grown So Fast for So Long* and from useful comments on earlier drafts by Pedro Conceicao, Selim Jihan and Leo Horn-Phathanothai.

conditions to generate and sustain development. And since transformation takes time, a process that unfolds over decades rather than years, a long term perspective to development becomes necessary.

Contemporary economists like Rodrik (2003) do not see any contradiction in taking a broader perspective to developmental change and conventional economics which rests mostly on neoclassical concepts and tools. The latter in Rodrik's view are sufficiently flexible to incorporate broader considerations like institutions and context specific conditions in the analysis of growth differences among countries. A distinction is drawn between neoclassical tools and their more 'vulgar' application of specific policies associated with Bretton Woods supported adjustment programmes of the 1980s and 1990s. In his view, core economic principles such as property rights and contract enforcement may not map into unique policy packages. Different approaches may work in different contexts, China being a good example of that. Still, good institutions are those that deliver core economic principles effectively.

Justin Lin (2010) takes a step forward in extending neoclassical analysis by presenting a framework to complement previous approaches in the search of sustainable growth strategies. This framework accepts that an economy's structure of factor endowments evolves over one stage of development to another. It presents the idea of infrastructure – both soft (institutions) and hard (roads) – as an additional factor of production, and accepts the important role of industrial policy and the state in promoting development. With markets as the basic mechanism for effective resource allocation, Justin terms this approach as 'New Structural Economics'.

Taking a transformative perspective, this paper examines the relationship between the key drivers of development: ownership, capacities and policies (Malik et al 2002). It looks at the interplay of reforms and China's overall guiding vision, examines the role of incentives and markets (as opposed to ownership), and the complex relationship between institutions, the state and people. Drawing upon this broad political economy perspective, the paper attempts to identify strategic and policy lessons that may be of interest to other developing countries. It is an attempt to contribute to an area, which may usefully be termed as 'Transformational Economics'.

2. Transformative linkages – some concepts

In a traditional society, there may well be alignment between the key development drivers: strong ownership of a coherent vision of society, institutions that manage the conduct of the priorities arising from that vision, social capital that sustains that level of development, and policies that nurture and sustain that vision and the needed capacities. Such societies may have high levels of institutional and social capital, though this may not in the form that facilitates change and development (Stiglitz, 1998). What stock of social capital exists might be destroyed in the course of development, or as in Russia, transitions may happen without the easy emergence of a new functioning social order and capital. This perspective leads to the proposition that public policy needs to go beyond narrowly defined state capacities to consider approaches that promote broader social capabilities – institutions, incentives and social structures that encourage productivity and entrepreneurship and reinforce the ability of governments to design and implement public policy.

Markets, prices, incentives all have a role to play in shaping development outcomes. Policies seek to influence them in one way or another. Macroeconomic stabilization has to be connected with longer term structural change imperatives. Spending on social sectors is generally treated as residual expenditures – that is, what is left over after more important matters are attended to and the country balances its budget. Social welfare policy is seen mostly as being about managing the impact of development strategies and programmes as governments seek to move their countries forward. Rarely are social expenditures viewed as investments for the express purpose of creating the social conditions that can accelerate and sustain growth.

Change inevitably shifts the relationship between the three drivers. Managing that change requires securing an alignment of the transformation drivers at higher levels of development. To illustrate: the first alignment of the three elements can be a stylized description of pre-reform Soviet Russia, where over time centrally planned policies had provided for the basic needs of the people. In terms of social norms, Soviet

citizens accepted as normal the availability of social facilities such as crèches in the work place, generous leave entitlements and widespread access to leisure. But income levels were much lower than in western economies. Comparing this with the situation of Russia post-*perestrioka* is revealing. The disastrous results are well documented – the collapse of incomes, a huge rise in inequality, shortened life spans – some unprecedented since World War II. Dramatic new policies were introduced (with support for the international community) without fully assessing their implications for the design or creation of new institutions and new social norms and networks that might have allowed for their success. While the failure of the 'big bang' approach is widely accepted, the fault may not have been just with the content of the new policies, but also in not having allowed for the context in which they were being introduced. One reason for this mismatch, which refers to the third development driver (policies), was that the 'experts' and agencies charged with assisting the transition saw it as a conventional problem of weak markets and democratic institutions requiring standard solutions in the form of more loans and more technical cooperation (Putnam, 1993) and Sachs et al. (2000).

Moving then from one system, or aligned level, to the other raised issues of absorption and sequencing. Much of the debate on 'absorptive' capacities is linked to the role of public policy in influencing the ability of developing countries to absorb 'new ideas, norms and techniques' (Koo and Perkins, 1995). In South Korea, this led to investing in education first so that the transfer of skills and knowledge through international assistance could be better absorbed. The East Asian crisis is a different example. Here the role of governments was well established, with generally strong, well managed institutions and a mix of policies mostly regarded as growth-friendly. And perhaps even more important, these countries had succeeded to a considerable extent in transforming their societies. So what went wrong? In this case the challenge was more in terms of policies and the global context. While critical observers fault the volatility of short-term capital flows and less than useful external advice (Radelet and Sachs, 1998), there was also serious questioning of key aspects of generally accepted policies such as premature capital account convertibility and inadequate financial supervision in developed country economies, a charge that has re-emerged in a major way in the current global financial meltdown. The East Asian and current crises call for more not less governmental action and for more and better international financial coordination and supervision, as was accepted by government leaders at the G-20 Summit meeting in London in March 2009.

An important part of the social transformation dynamic is how economic groups interact with the state. There is a dynamic aspect here, as these groups both contribute to and are influenced by state policy. Economic groups function within a context of a particular history and regulatory/institutional framework. A subset of these relations refers to civil society and institutional arrangements that mediate and influence the link between states and markets. The context then can either facilitate the interaction of different economic groups or undermine their capacity as civil society actors in the attainment of specific development outcomes. Such groups in turn can play an important role in shaping government policies and performance. Woolcock (1998) articulates it well: "the nature of state-society relations is thus crucial to understanding the prospects of economic groups and the efficacy if their role to influence the willingness and ability of the state (and other large corporate actors) to act in a developmental manner. The development effectiveness of state-society relations therefore turns on the articulation of the interests, needs and resources of both parties."

A range of development outcomes is possible. Extreme examples are the so-called 'failed' states, such as Somalia, where there is little state organizational capacity and where the state, and with it basic law and order, simply ceases to exist in any meaningful form. Economic groups in turn are unable to coalesce into any semblance of a working economy. The synergy is not there. These states are close to what has been described in the literature as 'predatory states'. There is a critical role here that leadership and elites play in shaping development outcomes.

Bangladesh is also an example of a country with relatively weak state capacities, but one in which a robust civil society and other factors have facilitated better development outcomes. Bangladesh has produced exceptional leaders like Prof. Yunus (Grameen Bank) and Dr. Abedi (BRAC) who in turn over the years have galvanized an increasingly large movement of civic leaders to re-invest in society. Bangladesh has made more progress on the attainment of MDG outcomes than any of the other south Asian countries including fast

growing India. Life expectancy went up 22 percent in eighteen years, to sixty-six years in 2008, and population growth declined to 1.41 percent, from 2.19 percent in 1990. Growth rates have kept steady at around 6 percent over the past decades.[2] The reasons for this are less to do with a developmental state or 'good' policy packages. Three key factors came together in a virtuous circle: gains in female literacy – mostly due to a combination of private sector needs for a better educated labour force (initially in the garments export sector) and related civil society investments; an extensive micro-finance network reaching many millions of the poor; and large remittances from Bangladeshi immigrants whose cash transfers led to direct increase in their family incomes. These factors came together and contributed to stronger social capital and energized longstanding entrepreneurship traditions that led to higher growth rates.

By combining direct and indirect data of social cohesion, Easterly et al (2006) confirm the results of earlier studies (for instance by Rodrik, 2000) that cohesive societies tend to grow faster than less cohesive societies and that the latter are better in dealing with crises and exogenous shocks. Countries that are deeply divided among caste, language and community, present large challenges for the best of leaders and policy makers. There is a virtuous aspect here. Good development outcomes are generally more likely in countries governed by effective public institutions and those institutions in turn are more likely to be found in socially more cohesive societies.

Calls to improve policies and institutions are based on an "implicit assumption….that realizing them is simply a matter of choice, technocratic skill, and/or sheer political will" (Easterly et al, ibid). Social and international power relations play a large role in determining the policy space that may in fact exist for leaders and governments in developing countries. A certain degree of social cohesion is essential to generate the confidence and commitment needed to carry out reforms. Citizens have to trust their governments. Inclusiveness of communities and institutions can act as shock absorbers in facilitating change, when reforms challenge existing power relations and class divisions. As societies transform, and being mindful of these relations, policy makers have to develop a broader reference for their policies and the intended impact of policy changes on society.

The success of unorthodox development strategies in East Asian countries, and the active role of government in driving these strategies, has given rise to debates among economists about the 'development state' – which refers to an 'activist' government and a political elite that see rapid economic development as their primary aim. Some go further and add an additional feature, a state that gives power and authority to the bureaucracy to plan and implement development policies. High rates of growth and the improvement of living standards in turn provides the state apparatus and the ruling elites their legitimacy (Abe, 2006). That governments are critical in shaping development outcomes in developing countries may appear as self-evident, however key questions then relate to how active should that role be? And what incentives are there to strengthen and sustain that role?

The development state explicitly recognizes that markets by themselves are not sufficient to produce rapid economic progress. Property rights may or may not play a critical role in this thinking – given, for instance the disparate development paths taken by South Korea, China and Japan. Originally outlined to describe the South Korean development experience, the term 'developmental state' has evolved into a concept to capture the role of government and state elites in driving development strategies that cannot be easily explained from a neo-classical perspective. There has been an unfortunate tendency, however, for observers to lump such strategies with dictatorships and free markets with democracy, implying that rapid progress cannot be easily achieved in democracies. Not all authoritarian regimes are developmental. Equally, states do not have to be authoritarian in order to be developmental. Examples like Brazil, India, as well as Mauritius and Botswana provide ample attestation that democratization and developmental orientation of states can occur simultaneously (Fritz and Mencal, 2007).

[2] World Bank, World Development Indicators. Available at http://data.worldbank.org/indicator

A larger, transformative role for governments is not without precedent. In the early stages of development, governments of the more advanced economies did play key roles in laying the conditions for later economic and social progress, be it in Japan after the Meiji Restoration of 1868, or in post-war Germany. For instance, the German government played an active role in coordinating decisions about investments in heavy industry, which stands in contrast to the more spontaneous growth of industry in the United Kingdom. Kornai (1992) goes further to argue that it is only when fundamental policies were flawed or institutions ill-equipped that even a proactive role of the state produced little result, as in the communist bloc. The context and sequencing of transformative development policies become important in determining the speed and efficacy of the development path.

Whether governments in reality are a positive or negative force for development depends on the 'orientations' they pursue and the relationships they seek to foster with society. How bureaucrats and society interact can be described as either: i) a 'grabbing hand', a model where the government is interventionist but not helpful – in this case, a large number of bureaucrats are pursuing their own agendas, including pursuing corruptive practices; or ii) a 'helping hand', where the government and bureaucrats are committed to promoting the positive action of society and promoting a unified development purpose. Several authors present a third category as well – the 'invisible hand' model, where the 'government is non-interventionist but well organized, generally not corrupt and relatively benevolent' (Frye and Shleifer, 1997). Presented as 'ideal types', Frye and Shleifer recognize that in actual practice most government are a mix of all three. The description of the last category, however, implicitly indicates a value-preference in favour of private enterprise and markets.

As governments function in a specific societal context, the nature of their interactions with economic groups can be significant in shaping development outcomes. In assessing comparable reform packages introduced in Poland and Russia, Frye and Shleifer (1997) argue that a key reason for the markedly different development outcomes is the very different relationships between government and business (society) in the two countries. By reviewing evidence from Moscow and Warsaw shops on their dealings with bureaucrats involved with legal and regulatory matters, Frye and Shleifer consider that the 'invisible hand' model is a better fit in describing Poland (a good outcome) and the 'grabbing hand' model in describing Russia (a less good outcome). Polish local authorities were more helpful to entrepreneurs and business generally.

The question remains as to what works and what does not, as policy makers struggle with new policies and new ideas to promote development. Perhaps there is not an either/or perspective here. What many of the ongoing studies have increasingly in common is their willingness to move away from simple explanations of growth differences. They reinforce the importance of understanding the context and initial conditions of growth, the role of institutions and the need to understand better the broader societal forces that policies and development strategies have to mindful of in order to influence development outcomes.

3. Defining characteristics of the China experience

Chinese development strategy and experience can be usefully characterized by:

- A strong vision of, and commitment to, development
- Local initiative and experimentation leading the way in much of the piloting and policy development
- Building constituencies for reform
- Part reformation was good enough – it was fine even if reforms worked in only one area of the economy
- The focus was on results and outcomes, rather than the means or even, for that matter, principles.

The term 'gradualism' or 'incrementalism' has been used by observers to characterize the nature and sequencing of reforms in China, even if there are continuing debates on whether gradualism should be defined in a narrow sense to refer to a situation where reforms require, predict or create economic exigencies for further reforms, or a broader interpretation where the term gradualism refers to giving sufficient time for policies and reforms so that they better accepted by the people.

Huang (2002) makes a distinction between the different periods of reform. He considers the 'gradual' description of reforms fitting better with the reformist policies in the 1980s than those pursued in the 1990s, and that, furthermore, it fits better the liberalization and opening up aspects of Chinese reforms.

There is also the view that Chinese reforms occurred in fits and starts, otherwise the 1980s reform should have 'predicted' a deeper wave of reform in the 1990s, a comment that is probably true in the case of SOE reforms. SOE reforms in the 1990s most likely would have been different if the reforms were indeed about privatizing SOEs, instead the state took measures to strengthen their position and created incentives for them to become more competitive.

Whatever the term used, it should be noted that profound reform even at glacial speed overall inevitably contains dramatic micro shifts, such as the introduction of household contracts on farm land, creating a market track beyond the state one, introducing liberal local policies in Special Economic Zones (SEZs), promoting incentives systems for SOEs, a merit-based civil service code, removal of lifetime employment, etc. Thus despite widespread western criticism for reforming too slowly, the Chinese government has often been criticized domestically for moving too fast, as these mini-bangs create disruptive waves in the social, political, institutional and organizational fabric of the country.

The economic success of China has produced a virtual torrent of books and articles by economists promoting the virtues of a gradual approach, as opposed to a 'big bang' set of policies introduced in Eastern Europe to mixed results. This conclusion, however, refers to one part of the overall argument. The reasons for China's success go much deeper. Four features of the Chinese experience can be highlighted:

3.1 EXPERIMENTATION AND LOCAL INITIATIVE

Perhaps the main argument related to this 'gradualism' or lack thereof is that it allowed a strategy of experimentation whereby ideas and models could be tested within a limited scope in the provinces – where innovative ideas also sometimes originated, another feature that will be touched upon below – and disseminated or enshrined in national policy only after having proven its worth.

Apart from avoiding costly mistakes and stimulating innovation, the scope for caution and stepwise decision-making afforded by this strategy also allowed the building of greater consensus and stronger constituencies around further reform. The fact that some reforms were never extended beyond certain localities did, however, sow the seeds of today's vast regional disparities. Harrold (1992) argues that:

"Perhaps the greatest advantage of the decentralization approach has been to create interest groups in favor of further reforms, and to foster a climate for reform initiatives and 'spontaneous' reform at the local level. Many central reforms are 'enabling', in the sense that they remove central prohibitions [and] local reforms frequently spread, [which] not only helps to build up increased confidence and interest in reforms, [but] also creates innovative approaches to reform".

One of the areas where this experimentalism is most obvious – and controversial – is that of institutions. In contrast to the commonly expressed view by more traditional economists that institutional innovation only held Chinese growth back, some have argued to the contrary, that such innovation was helpful or even necessary given Chinese conditions. Qian (2001) notes:

"Although building best practice institutions is a desirable goal, getting institutions right is a process involving incessant changes interacting with initial conditions. The difference between China and Russia is not at all that China has established best practice institutions and that Russia did not. The difference lies in the institutions in transition.

To understand how reforms work in developing and transition economies, we need to broaden our perspective on institutions. It is not enough to study the familiar forms of conventional institutions found in the most developed economies as a desirable goal; it is also essential to study the variety of unfamiliar forms of

institutions in transition. The distinction between the conventional, best practice institutions and the transitional institutions is important".

An important characteristic of the above process is that the distinction between top-down and bottom-up initiation becomes somewhat fuzzy and perhaps not even so relevant. Heilmann (2008) puts it succinctly, "distinguishing between bottom-up (spontaneous) and top-down (mobilization-style) initiation of experimentation is nearly meaningless since there is a strong element of both. Local initiative and central sponsorship, both were vital in the initial stage of major experimental efforts. Neither works without the other. The dynamics of the experimental process rest precisely on this interplay". China's adaptive capacity in policy making goes beyond local tinkering, it is probably better characterized as "foresighted tinkering under the shadow of hierarchy, serving policy agendas that are constantly set and reset by higher levels" (Heilmann, 2009).

3.2 BUILDING CONSENSUS FOR REFORM

A key aspect of China's 'gradual' approach, important to its eventual success, is that it provided a smoother and more easily acceptable transition. In transition, there are inevitably losers. Conducting reform without creating losers has been an implicit guiding principle since 1979, and the dual track system is a concrete expression of that principle (Lau, Qian and Roland, 2000).

By allowing the economy to "grow out of the plan" – in the famous words of Naughton (1995) – this approach was less disruptive socially, economically and politically than the *big bang* experiences of many other transition economies in Europe. It reduced opposition to change by providing security and compensation to potential losers, while also providing stability and the time to reorient preferences and expectations.[3]

Crucially, the competitive pressures from the expanding private sector is also cited by many observers as having a considerable impact in forcing efficiency improvements in the SOEs without the need for either privatization or large scale lay-offs.[4]

While it is generally acknowledged that maintaining job security and economic rents in the state sector also preserves inefficiencies, the argument is made that more disruptive reforms would have created social costs important both in themselves and for their potential in eroding support for the reform process itself.

Along these lines, it has also been argued that the high household savings rates that made possible the rapid capital accumulation emerged partly as a response to a combination of fulfilled expectations and a stable economic environment that was maintained throughout the period.[5] In this view, factor accumulation should not be taken at face value but examined more closely, in search of underlying factors due to the characteristics of the reform process.

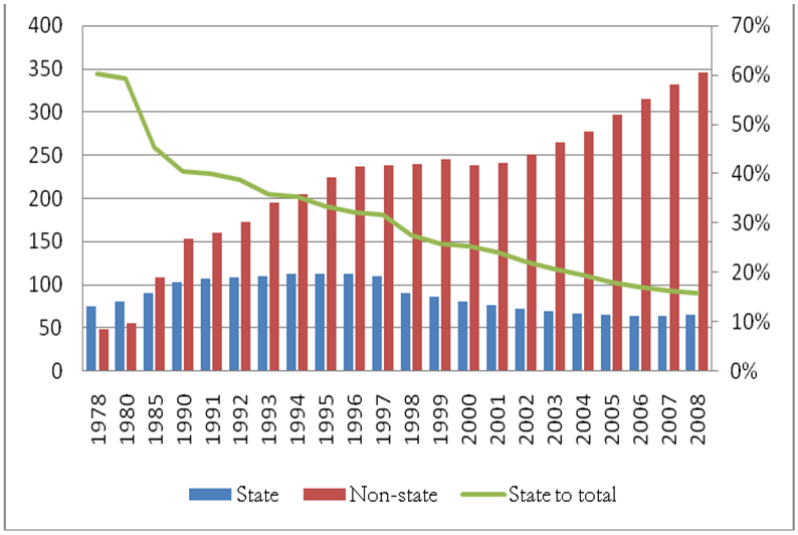
[3] Naughton (1995)

[4] See for instance Naughton (1994), which shows that SOE output grew by 7.7 percent per annum 1978-1991

[5] Naughton (1994)

Figure 1. Dual tracks in non-agricultural employment

(Millions of People)



Source: NBS. Based on Lau, Qian and Roland (2000) and updated

The Chinese dual-track (state and non-state) system can be seen as implicit lump-sum transfers to compensate potential losers of reform. The product market in fact came close to full liberalisation since resales, subcontracting and purchases for redelivery were permitted. Labour markets and real estate markets however were not liberalised to the same extent.

This approach constrasts with the *big bang* approach, which *inter alia* assumes a high degree of transferability of institutions from one society to the other, reflecting the underlying paradignm of modern economics – an equilibrium-oriented approach that says 'get the prices right, and the rest will follow'. In reality, as the Chinese experience also demonstrates, social change is a highly complex, unpredictable phenomenon (Chen, 1993).

3.3 PART-REFORMATION

One aspect of gradualism was that some sectors were reformed while others were not; indeed many sectors were partly-reformed along the lines of the dual-track system. Some observers have pointed to the fact that more marketized sectors and tracks have grown faster than non-marketized ones. While this is not surprising – since it is the main rationale behind marketization – it does not follow that expanding marketization to all sectors of the economy at once would have produced a better overall outcome. Indeed, if the sequencing of reform across sectors has an impact on the stability of and support for the reform process itself, the opposite may be true.

The trial-and-error approach is arguably key to understanding the 'socialist market economy' and guiding visions as well as the choices made by reformers. The unorthodoxy and pragmatism of this approach have been core features of China's reform process, and despite generating solutions seen as heretical by some, it is hard to argue that they have not delivered – although counterfactual cases with still higher growth can always be constructed.

Economic theory has developed the concept of *second best* to describe solutions that are less than ideal, but optimal given the constraints of a specific context. Irrespective of the general sense of imperfection that bedevils this concept, much of China's institutional reform can be usefully thought of in this way. Examples of such institutional *second best* solutions that increase efficiency in a non-optimal context include the pseudo-

public ownership structure of the Township and Village Enterprises (TVEs) the dual-track pricing system and the fiscal contracting system.[6]

Qian (1999) notes that:

> "Through experiments and innovations, a variety of transitional institutions emerged and many of them took unconventional forms. They were second-best arrangements but quite effective in providing incentives. As a result, China's reform in this stage was much deeper, more comprehensive, and more consistent than that in Eastern Europe prior to 1990, which helps explain why reform was a success in China but not in Eastern Europe".

3.4 PRAGMATISM (NO 'FIRST-BEST' POLICIES)

The gradual approach was in essence a reflection of the pragmatic nature of the Chinese leadership. Far from starting with a predetermined blueprint for reform or even a clear vision of the end goal, the reformers began with the purpose of addressing a specific and limited set of increasingly obvious economic problems. The impact of the initial measures often gave rise to new issues, however, which were addressed with further reforms in a similarly pragmatic fashion. The leaders thus stepwise proceeded down a path of reforms never originally intended – in great contrast to the plans proposed for transition in EEFSU (the Eastern European and former Soviet Union countries), often accused of being partly ideologically driven. This readiness of the Chinese leadership to respond to emerging issues with deepened reform has been outlined as an important factor in China's success.[7]

This pragmatism is arguably seen also in the relative tolerance for unexpected phenomena, whereby the leadership accepted unorthodoxy and unanticipated developments as long as they delivered the results that were asked for – chiefly economic growth. Perhaps the most important example of this is the TVEs, whose major role in the growth of the 1980s and early 1990s was never anticipated by anyone, including Deng himself.[8]

Deng's dictums "go a step and look for the next", "feeling the stones to cross the river" and "seek truth from the facts" all depict with clarity the very pragmatic thinking that has shaped China's approach to reforms. It is a pertinent and revealing exercise to compare this with Vaclav Havel's view of Eastern European reform experience, that "you cannot cross a chasm in two leaps".[9]

Another reason for this pragmatism may have been the perception that transition was impossible to plan, perhaps compounded by disillusionment vis-à-vis the planning system as a whole, as the failures of the socialist economy had proven its limitations.

The pragmatic, gradual approach has also implied responsiveness to unexpected needs and challenges. For instance, the competition engendered by the entry of non-state enterprises, starting with TVEs, propelled a variety of management reforms in the state enterprise sector (introduction of a profit tax, greater autonomy in production decisions, greater management freedom etc). Reforms at the corporate level in turn highlighted the need for and actively induced further adjustments at the macro level.[10]

This fits well with the notion of 'induced institutional change' put forth by several authors.[11] China 'pragmatism' can thus be described as a needs-sensitive, results-based and somewhat risk-averse approach to reforms. Rawski (1999) goes further to argue to that the most important feature of Chinese reform has been its

[6] As argued variously by Naughton(1995), Oi(1992), Rawski(1999)
[7] Naughton (1994)
[8] Deng (1994)
[9] Bhagwati(2004)
[10] Bajpai and Jian(1996)
[11] Lin (2004), Chen (1993)

interactive nature. Even the slogan 'crossing the river by feeling the stones' may give the wrong impression by implying a clear goal when none existed. Early reforms were tentative, partial and consistently focused on enabling rather than compulsion.

As the Chinese (and related) experiences indicate, strategies that can effectively deliver on 'development as transformation' may require: a coherent *long term* development vision; *'gradualism'* in the application of development strategies as it reduces disruption and raises chances of success, or policy shifts that are given time for people to adjust to; and, *pragmatic flexibility* in policies to meet needs as they emerge may be more effective than having a predetermined blueprint based on economic orthodoxy.

4. Growth enhancing factors: the 'Tao' of development

4.1 OWNERSHIP

National ownership of a 'long term developmental vision' is a necessary condition for long term, sustained development. Strong, consistent leadership is required to sustain that vision.

While ownership is intrinsically an elusive concept, some key dimensions can be highlighted. This paper defines ownership as the independence and self-sufficiency of actors to make plans and decisions as well as the buy-in at lower levels of plans and decisions taken at higher levels. Leadership, a related concept, is fundamentally an exercise of will by specific actor(s) and the ability to bring along others towards a specific objective. Visionary leadership in the development context is about the ability of an individual or a group to understand the imperatives of a nation and its future and forge a constituency in favour of change and progress.

4.1.1 CONSISTENT, LONG-TERM COMMITMENT TO REFORM

That development transformation takes time may seem a self evident fact but it has profound implications for development policy and strategy. It raises questions as to how to balance short term concerns with longer term imperatives, a question of considerable relevance for most developing country governments especially those democratically elected and with relatively short governance time spans. It raises issues of consistency of policy and reforms over time. While it underscores the central importance of taking a long view, it raises the obvious questions of what are the key transformative policy actions, the essential conditions for sustaining reform, and indeed the process itself of setting priorities since circumstances and challenges may profoundly vary over time.

Transformation of society and the economy is inherently a long term, gradual process, and in China the astonishing changes that have taken place were allowed to take time. This gave both people and institutions a chance to keep up with changes and adjust their mindsets, preferences and expectations at the relatively modest Chinese pace of policy reform.

In the Chinese Communist Party (CPC), while there was and continues to be an ongoing struggle for the positioning of specific views in shaping development strategies and priorities for reform, this struggle was not allowed to dislodge the essential directions of the reforms and developmental vision introduced by Deng Xiaoping in the late 1970s. Within the Party, there has been a core leadership that was deeply committed to improving long term growth, and had a clear, pragmatic approach to development. The difficulties of the past, the unsettled situation during the civil war period, and the eventual triumph of the communist party has left an indelible impact on official attitudes and their commitment to economic and social progress of the people. If specific experiments produced positive results, they became in time policy. The state in China was not as had been described in the literature as a 'grabbing' hand. In acting on its development vision, it was pragmatic and fairly consensus-based.

The *Four Modernizations* (modernization of industry, agriculture, defense and science and technology), *Xiaokang*, the scientific approach to development are all terms which emphasize different aspects of the same vision. The remarkable feature of Chinese developmental direction since reforms were launched in 1978, has been one of consistency and adherence to Deng's vision of modernization and its focus on unleashing China's

productive forces. In many ways, Deng Xiaoping set the standard for future leaders by articulating a middle path of a 'socialist market economy' as one of forging a 'third' way between capitalism and the Soviet style approach to a command economy. Since then, adjustments in policy or direction can be categorized as attempts to fine tune policies, respond to emerging challenges, and, drawing upon Chinese terminology, to 'respond to facts on the ground'. For instance as disparities widened in the late 1990s, and with it concerns about social stability, Premier Wen Jiabao in his 2005 address to the National Peoples Congress (NPC) signaled such a directional shift by stating that henceforth urban areas will support rural areas, and industry would serve agriculture, a reversal from earlier strategies[12]. But the commitment to growth remained, and to the Four Modernizations.

At the overall, strategic level, development strategy in China was not driven by any grand blueprint for reform. It was guided by an overarching vision of modernization and crucially was underpinned by social and political arrangements that encouraged participation and coalition building. Difficult questions of what kind of society the Chinese wanted for themselves and what they could realistically hope to achieve in a specific context were part of the constant dialogue and interaction on policies among different groups and constituencies. It was consciously recognized that there were clear trade-offs between a blueprint represented by the many plan documents and ground realities. This dynamic tension between what may be referred by some as best-practices and local realities is captured well by Rodrik (1999):

> "Blueprints, best practices, international codes and standards, harmonization can do the trick for some of the narrowly 'technical' issues. But large-scale institutional development by and large requires a process of discovery about local needs and capabilities."

Whether an intentional strategy towards a distant goal or an unintended *ex post* outcome of disagreements on the scope of reform, the gradual, step by step approach taken by China has been highlighted by many observers as a crucial reform aspect with intrinsic benefits.[13] And, importantly as some have observed that, intended or not, there was a certain 'ex-post coherence' of Chinese reforms (Naughton, 2007).

4.1.2 STRONG NATIONAL OWNERSHIP, COHERENT LEADERSHIP

In the development field, one clear dimension of ownership is that of a country's independence from undue outside influence in the processes of policy making and implementation. Examples of weak ownership that come to mind include developing nations especially those in Africa in the 1980s subjected to the aid conditionalities of structural adjustment programmes mandated by IFIs based on Western experience, priorities and interpretations. The blame for the failure of these programmes has often been placed on the lack of regard for or understanding of the local context that characterized the policy recommendations given by the outside advisors upon which loans were conditional. Local governments who were more aware of the local situation, however, were in a weak bargaining position and had much to lose from not receiving the promised funds.

China presents an important example of strong national ownership on several levels. The nature of the reform process itself and the institutions that were created – pronounced as unorthodox by outside observers – illustrate amply the independence of thought and implementation that Chinese leaders have displayed vis-à-vis traditional economic thinking and the policy advice received over the years. Since the Communist Party took over in 1949, Chinese attitudes and policy setting processes have been influenced by a deep seated desire not to repeat the 19th and early 20th century experience when foreign powers were able to dictate terms to weak Chinese administrations. At the same time Chinese leadership and its administration were eager to see and learn, but adamant in retaining the prerogative to adjust any lessons to their perception of the Chinese reality

[12] Report on the Work of the Government (2005) Delivered by Chinese Premier Wen Jiabao at the Third Session of the Tenth National People's Congress on March 5, 2005, Available at http://www.gov.cn/english/official/2005-07/29/content_18351.htm

[13] The unorthodox nature of Chinese reforms is captured by Qian (1999) when he states, 'the Chinese path of reform and its associated rapid growth seem to defy the necessity part of the conventional wisdom: Although China has adopted many of the policies advocated by economists, such as being open to trade and investment and macroeconomic stability, violations of the standard policy prescriptions are also striking"

and the constraints therein implied. Nolan (2004) underscores the deep rooted nature of China's independent thought and polity, stretching many centuries.

China is seen as the embodiment of an active, developmental state. Its enthusiasm for development is a critical factor in driving China's success. This activist role did not come by accident, as this change in behavior of the Chinese government was an outcome of specific bureaucratic reforms that had a two-fold purpose: one, to change the human capital composition of the bureaucracy, with younger, more educated officials replacing older, more revolutionary cadres, and second, through extensive administrative and fiscal decentralization to empower lower level administrations (Li, 1998).

The outcome of this step and a series of related measures meant that the Chinese government has overall provided a relatively 'supporting hand' in furthering economic growth, with despite the lack of political liberalization, a bureaucracy transformed into a force supporting economic reform and economic development. In the transformation framework outlined earlier, state attitudes go some ways in explaining development success.

Leadership. Articulating a coherent vision of the future is important and in that China has remained consistent over the reform period, but sustaining such a vision has been arguably even more challenging. At different points in the 1980s and 1990s, Deng's vision was severely questioned and tested. This period serves as a vivid illustration that leadership matters. Post Tiananmen, the rise of conservative factions raised doubts about the future of economic reform in China. The abortive Soviet coup of 1991 and the collapse of the Soviet Union had strengthened the hands of Chen Yun and the leftist ideologues at the expense of Deng and the reformers. Both in the media as well as within the party there was a concerted attempt to discredit Deng's policies of reform.

Deng realized that winning the political (and ideological) debate within the higher echelons of the party was difficult. He further recognized that communicating with the people directly was particularly difficult in Beijing due to the tight party control over the media. Deng's leadership ability showed in his ability to identify and carry out a strategy to garner support in China. More importantly, to paraphrase Caro's description (Caro, 2002), Deng was able to focus on the key purpose of the reforms, amid the many proposed policies, the ones that would best accomplish a larger purpose...i.e. to "*give the people economic space and the rest they could start doing by themselves*".

Deng also recognized that he would need to mobilize support for his reforms by travelling around China and directly address his followers. Accordingly, he undertook the unprecedented 'Southern Tour', travelling to the Southern provinces in general and Guangdong and Shanghai in particular (Ash and Kueh, 1996). A single leader, however charismatic and gifted, is not enough to shift historical forces. Bringing along followers becomes necessary, both those directly in support and those referred to earlier as 'fence sitters'. As pointed out by Zhao (1993), while Deng's skill in choosing both the right time and place to take on the central party hierarchy was important, success would not have been possible without the support of his followers in the regions which had been the direct beneficiaries of the reforms. Deng emphasized the importance of broad based economic development and reform to communicate with his followers and the lower level hierarchy in the party, using it as a way to criticize (and isolate) the ideological hardliners (Naughton, 1993). The response to Deng Xiaoping's appeal by both his followers and non-followers was immediate. Deng's supporters used his Southern tour to mobilize opinion, lobby and put pressure on the party hierarchy; thousands of cables and letters poured into Beijing party headquarters expressing support for Deng's policies. Not surprisingly, Deng's Southern Tour is widely regarded as single-handedly shifting the political momentum decisively and irreversibly in favour of the continuation of economic reform in China.

Another test of leadership took place in the early 1990s, when after economic over–heating and the events at Tiananmen, there was a backlash by conservative factions against reforms. However their efforts at reversing reforms and re-nationalizing assets failed when the Governor of Guangdong province and the Mayor of Shanghai refused to turn in more revenue to the central government, with many others following their lead.

Political deadlock ensued at the center but did not impede further reform, as provinces simply pushed ahead on their own. Guangdong province took a lead in prize liberalization, which led to near complete removal of the dual-price system nationwide by 1993. Deng and his supporters in Beijing provided the critical central level support needed to continue with reforms.

Since then and following the departure of dominant leaders like Jiang Zemin, China has moved more fully towards a model of collective leadership which requires consensus on key policies and directions. Whatever the exact form of strategic decision making, an abiding factor has been an absolute determination by China to take its own decisions based on their assessment of national conditions and requirements.

4.1.3 IN A LARGE COUNTRY, OWNERSHIP IS PARTICULARLY IMPORTANT AT THE LOCAL LEVEL

China is a large, complex country. Ownership of reforms requires a buy-in at many levels. There is a long tradition as well of China being fairly decentralised in economic terms, despite the more popular image of a powerful Beijing issuing instructions that are faithfully followed by the provinces. Even in ancient times, this was the case, which is well captured in the Chinese saying, *tiangao huangdi yuan:* 'the sky is high and the emperor is far'.

In the 1950s, Mao's reforms including the introduction of land reforms (covering land re-distribution and its use) initiated a process of economic decentralization. Specifically, in April 1956, at the meeting of the Political Bureau, Mao addressed the issue of central-local relationships. Once central leadership had been consolidated, it was Mao's view that local authorities should be given more powers so that they could have more independence and could do more things. He added that it was important to mobilize enthusiasm both at central and local levels, because China was a huge country, had a big population and faced a complex situation.

Some scholars hold the view that Mao ruled China through 'political centralization but administrative decentralization' (Blanchard and Shleifer, 2001). This laid a good foundation for the later reforms of Deng Xiaoping. It was only much later, in the early 1990s, that during Zhu Rongji's premiership attempts were made to re-centralize some economic functions, for instance taxation and fiscal arrangements to ensure that the centre could keep a higher percentage of the revenues raised through taxation.

There is a group of arguments connected to this relatively large degree of decentralization that has characterized the Chinese reform process over the years. Qian (1999) notes that even in the early days "the Chinese planning system was very much decentralized along regional lines, and local governments played an important role in economic decision-making and resource allocation. Related, central planning was usually crude, aggregated, and not comprehensive, and moreover, it was not 'tight', meaning that plan fulfillment often was not a binding constraint." These prominent features represented a significant departure from the textbook model of the Soviet system, and proved important for the evolution of reforms in China.

One aspect of decentralization was the level of grassroots initiative. The experimentalist approach of piloting and scaling up was characterized by a laissez-faire attitude to change that left considerable scope for change to happen spontaneously and organically.

Various reasons have been put forward by scholars to explain the absence of a comprehensive reform blueprint at the beginning of the reform process: the need to deal with a variety of urgencies in the wake of the Cultural Revolution; the lack of understanding and capacity of leaders to comprehensively plan for reforms; difficulty in reaching consensus given diverging interests across layers of administration and authority; the inherent difficulty in planning a process as complex as transition and so on (Garnaut and Song, 2004).

Whatever the underlying reasons, this tolerance of heterodoxy gave reforms an enabling character, allowing initiatives to percolate from below. Those successful would be repeated by other provinces and, as evidence mounted, eventually enshrined in national policy. Experimentation would typically take place at the regional/city, sector or enterprise level. In case of failure it would be stopped, in case of success it would be extended to other areas and enterprises. While sometimes suspicious of unconventional initiatives taken at

lower levels, the Chinese leadership refrained from suppressing them – a tolerance that may well be their greatest contribution to the reform process.

4.2 CAPACITIES – THE ENGINE THAT DRIVES AND SUSTAINS DEVELOPMENT

Investing in capacity occurs at three levels – at the *level of the individual (capabilities)*, at the *level of institutions*, and at the *level of society (social capital)*. It is posited that investing in capacity increases not only growth directly but also raises the prospects of successful development transformation.

Several propositions can be highlighted:

- The importance of social policy. Investing in human capabilities becomes almost a pre-condition to both start and sustain development progress.
- The state has an active role to play in managing transformation by creating the corresponding capacities and institutions (through public investment, influencing norms, defining policies).
- *Strong institutions* are necessary to successfully manage development transformation. States need a strong *results orientation.*
- *Good social capital and cohesion* ensures continuity and stability in the flux of transformation and raises growth through cultural factors like work ethic and openness to change (*building constituencies for reform, compensating losers*).
- *Human development investments* need to be broad based and transformative in character.

4.2.1 HUMAN CAPABILITIES

"[A] country's potential for rapid growth is strong ... not when it is backward without qualification, but rather when it is technologically backward but socially advanced" (Abramovitz, 1986).

One important conclusion coming out of the empirical work by Ranis and Stewart (2006) is that, due to the strong interrelationship between economic growth and human development, countries must promote both in order to sustain either. Economic growth provides the resources needed for significant investments in human development; but growth is also not sustainable without such investments. There are links in specific areas also. For instance, keeping inflation low, a traditional priority of macro-economic policies, has a human developmental aspect as well, since high inflation tends to hurt most the poor and disadvantaged (Elson and Cagatay, 2002).

China's population at the outset of reform was far more educated and in better health than comparable countries. Average schooling in the adult population rose from less than one year in 1950 to four years in 1980 and to six years in 2000. Without the foundation laid by Mao, Deng's pro-growth reforms could not have been so profoundly successful. And the emphasis on upgrading health and education remained during the reform period even if the strategies changed. It gave the broad masses of Chinese people, especially its labourers and managers the capability to respond effectively to new incentives and opportunities.

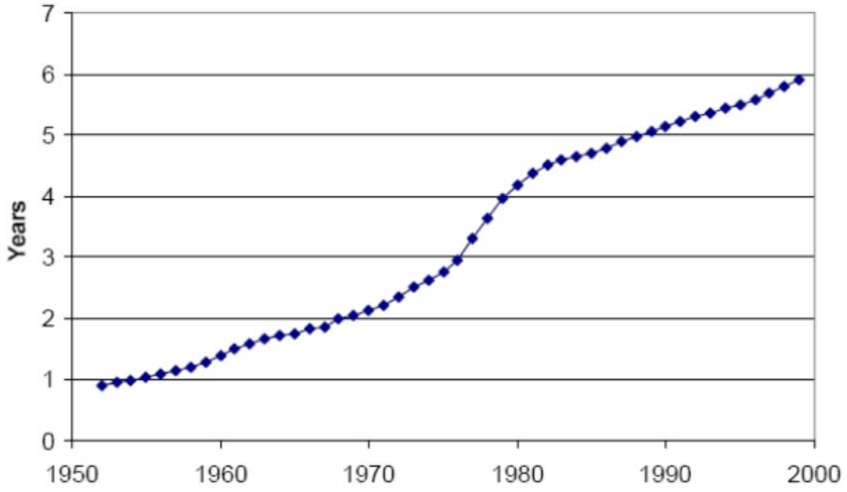
Different trajectories are possible. In the period until 1980, Chinese investments in improving health and education outcomes for the entire population saw child mortality drop to levels that compared well with most other developing countries. Economic growth, however, was slow and erratic, as the economy remained mostly under the plan. Later China experienced a combination of rapid economic growth and slower improvements in infant mortality. Comparing China with India, in 1979, at the start of reforms, China had a life expectancy of 68 years, compared with only 54 years in India. Yet the relative neglect of public health over the years, and an embrace of private sector incentives in the provision of health care in China, led to a situation in which, despite rapid and sustained growth over decades, life expectancy went up only marginally, but was still high at

74.5 years in 2010.[14] India is now at 66.5 years,[15] the gap between the two countries having narrowed significantly.

Investing in people pays dividends at many levels. Whether the investment is in health or education or social insurance, as has been argued it improves the capabilities of people to engage in the economy and society. It raises the quality of the labour force and facilitates societal adjustments that transformation of necessity requires. As this paper has highlighted earlier as well, prior investments in health and education allowed for a favourable start up of the Chinese reforms, and continuous investments enabled and fueled an active engagement by the Chinese people in the process of economic growth when it got started.

A critical transformative measure by the government was to commit itself early on to the *right to educatio*n – by making grade 1–9 schooling compulsory. By 2004, almost 18 years after the passing of the Law on Compulsory Education, the nine-year commitment had been instituted in a high 92.6 percent of the population. Enrolment rates at primary and secondary school levels have been increasing over the years, reaching almost 100 percent in the late 1990s. At the national level, the completion rate of 1–9 years of education was 75 percent by 2001. Challenges of course remain. By 2003, China still had 381 counties that had not succeeded in making this commitment universally available. Similarly, in the more than 60 years since the founding of new China, the *campaign to eliminate illiteracy* has never stopped. From a high of 33.6 percent of the population who could not read or write in 1964, a staggering 233 million people, illiteracy in China was reduced to 22.8 percent by 1982, or about 230 million people, and then brought down to 6.7 percent in 2000, or 85 million people[16] .

Figure 2: Average schooling years of China's population aged between 15–64 for the period 1952–1999



Source: Wang and Yao (2001)

In response to concerns about widening income disparities between urban and rural areas, much of the education spending in the early 2000s was then targeted on rural areas. In 2006, 70 percent of the government's new expenditures went to these areas. By 2007, the goal of universal primary school enrolment had been mostly realized, meeting one of the MDG targets several years in advance with some indicators in education comparable to or even exceeding those in industrialized countries. Nonetheless, there are continuing

[14] CIA: The World Factbook

[15] ibid

[16] According to China's Fifth National Population Census

challenges. When comparing education expenditures as a percentage of GDP, China, at 3 percent in 2008[17], is still below that of the United States at 5.4 percent of GDP and South Korea at 3.7 percent of GDP.

Many commentators have pointed to the importance of the early emphasis of the East Asian states on universal education. For China, a 2001 World Bank paper[18] studying the impact of human capital on economic growth concludes that human capital has contributed significantly to growth. The study, however, breaks human capital accumulation out of total factor productivity (TFP), which it also finds to be significant and contributing 2–3 percentage points to growth. This leads it to take a middle ground in the debate: arguing that both factor accumulation and productivity growth have been very important for growth. The study concludes that the importance of factor accumulation seems to be decreasing and productivity (TFP) will thus be the key driving force in future growth.

Concerning health, China's average life expectancy has steadily risen from a relative high of 67.8 in 1981 to over 72.4 in 2007. As with education, the big push forward in health indicators took place, however, earlier in the 1950s and 1960s, as Figure 3 brings out. Infant and maternal mortality rates have similarly sharply improved. And, as with education numbers, there are wide variations among provinces, with the maternal mortality rate (MMR) in Shanghai at 9.6 and Guizhou at 111.0, and between different categories of people, for instance, migrant women, who represent only 10 percent of urban pregnancies, account for two-thirds of maternal mortality.

While there has been an ongoing improvement in health outcomes over the reform years, there has not been a concomitant increase in health spending by the state, which raises questions for the future.

From 1980 to 2000, as the result of growing dependence on markets and a delinking of social care provision from state supported work units, the Chinese state was spending a declining percentage of GDP on the provision of healthcare services. The reversal of the trend in the later years however only marginally reduced (by 10 percent) the proportion spent by households on health, to 49 percent in 2006 (as opposed to 21 percent in 1980). China continues to under-spend on health. The 2003 SARS experience highlighted many of the challenges and shortfalls of the public health care system. The years of underinvestment in the sector showed in the inadequacy of the health sector response. In reviewing the health systems of the 191 countries, WHO (2000) ranked China 144 in terms of overall performance and 188 in the equity of health financing. Recent surveys have shown that health costs may be responsible for 33 percent of the newly poor. 80 percent of the rural population and 50 percent of the urban population are entirely uninsured for medical costs

These trends raise concerns for the future and have led to widespread calls for a renewed state commitment for comprehensive health reform.

Similar conclusions emerge from a comparative analysis of India and China by Bloom et al (2006). They point to rapid increases in life expectancy and declines in fertility in explaining growth, even if in both cases the magnitude of the effects is greater in the case of China than in India. Increase in life expectancy is taken as a proxy for population health. This finding confirms other studies, including a cross country study of growth rates by Bloom et al (2004). This and other studies confirm that better health and nutrition led to substantial improvement in productivity, and hence growth, in China.

There is yet another dimension here, which connects human development investments to institutions and their effectiveness. According to Djankov et al., 2003, each community or nation faces a set of institutional opportunities, determined largely by the human and social capital of its population. The greater the human and social capital of a community, the more attractive are its institutional opportunities. Indeed, Glaeser et al, 2004, argue that institutions have only a second order effect on economic performance, with the first order effect coming from human and social capital, which shape both institutional and productive capacities of a society. They consider the economic success of East Asia in the post-war era, and of China most recently, as a

[17] National Bureau of Statistics of China

[18] Wang and Yan (2001)

consequence of good-for-growth policies with human capital investment playing an important role, not of institutions constraining them.

4.2.2 INSTITUTIONS

a. Property rights and incentives

Institutions influence and shape incentives in human exchange, whether political, social or economic. More specifically, the term 'economic institutions' is used to refer to property rights and the nature of markets. Many economists consider that property rights are the bedrock of economic growth and development:

> "Efficient economic organization is the key to growth; the development of an efficient economic organization in Western Europe accounts for the rise of the West" (North and Thomas, 1973).
>
> "we have only to contrast the organization of production in the Third World economy with that of an advanced industrial economy to be impressed by the consequences of poorly defined and/or effective property rights" (North, 1990).
>
> "Property rights are…a key aspect of market-supporting institutions" (Rodrik, 1999).

By the above statements, China is a major outlier. The Chinese experience provides compelling evidence for that discussion, by demonstrating that control rights and residual claims can generate incentives every bit as effective as formal property rights. The often-heard counterargument that growth took place outside the state sector is somewhat misleading, since the collective sector was in many ways an extension of local governments, only with hard budget constraints and residual claim rights.[19] It can be pointedly argued – as this paper does – that in the 'development as transformation' thesis, ownership of *reforms* may matter as much as that of property. Similarly, privatization may matter considerably less than competitive pressure through domestic entry and opening to trade.[20]

Lin (2004) argues that stabilization and liberalization can be implemented fairly rapidly whilst:

> "Privatization may take a number of years to accomplish [and] the development of market-supporting institutions such as legal and financial systems, will take years or even decades. [Therefore] no matter what approach is adopted, the transition from a centrally planned system to a market system in any country in fact will necessarily be a gradual process".

The argument has also been made that given the lack of standard capitalist managerial disciplines in the first phase of transition from a command economy, there is a need for the state to oversee managers, which is naturally easier in sectors that remain under state control. The Chinese experience would appear to present evidence that the managerial incentives can be adequate under such conditions, given the reasonably strong performance of the state owned enterprises (SOEs) sector in the reform period – while avoiding plundering of public resources in relatively anarchic states.

According to the same author, China's transition process can be best described as an 'induced institutional innovation' process, whereby incremental changes, 'cracks' into old institutional structures have 'self-propelled' more radical 'market-oriented' shifts, but in a non disruptive manner, in a way that left people with enough time to absorb, adjust to changes.

This is echoed by several studies, including Chen (1993), which argue that the decentralized change so typical of China's experience is effective because economic institutions by necessity must be self-organizing and develop in an evolutionary process. In the words of Harrold (1992): "reforms in one area lead naturally to reforms in other areas, and indeed force those reforms by creating pressures for change […] and policymakers have in general seen their interests served best by meeting such pressures with new reforms rather than by administrative protectionism, albeit sometimes with a considerable lag".

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[19] As shown by Naughton(1995), Oi(1992) and others

[20] As argued by McMillan and Naughton (1992) and many others

This tolerance of heterodoxy fostered innovation in institution-building. The 'gradualness' of China's reform, then, was not a conscious design of the central government, but rather the inevitable result of compromises among a myriad of conflicting proposals, through a long process of trial and error. China's success demonstrates the effectiveness of providing time for learning and adaptation. Through experiments and innovations, inevitably a variety of transitional institutions emerged, with many of them taking on unconventional forms, perhaps more suited to the specific Chinese conditions. For instance, only gradually has the dualistic system been replaced with institutions that are perhaps closer to international standards. Qian (1999) again notes that "this process is…different from some Eastern European countries in that the new institutions are built before the old ones are destroyed."

Some interpret moves in recent years towards more traditional institutions – such as the constitutional revision in 2004 to give private property the same legal status as public property, the emphasis on rule of law and the many changes required by WTO accession – as *ex post* evidence of the validity of the *big bang* school of thought and the inevitable converge with best practice institutions (Sachs and Woo, 2003). This appears, however, to miss the point made by those suggesting that since institutions require time to change and the need for change was so great, gradualism was a core factor in success – which holds true even if one agrees that the standard set of neoclassical institutions are the only appropriate end goal. Rodrik (1999) is of the view that what has driven growth in China has been the move towards a market economy. For such an economy to succeed, it has to rely on a wide array of non-market institutions to perform certain functions, generally to regulate or support markets. He makes the important point that the "institutional basis for a market economy is not uniquely determined" (ibid).

Ownership reform in China has been less dramatic than some of the studies have characterized, certainly less than the proposed privatizations of most EEFSU countries. Farmers under the household responsibility still had to meet state mandated production targets. Under the reforms, managers in SOEs were allowed to retain a portion of profits, but the supervising entities could still transfer the devolved rights among the managers. It is therefore significant that several economists, including Naughton, find that the reforms "have improved managerial performance in China's SOEs by strengthening incentives generated by pay and appointment mechanisms" (Putterman,1995).

The debates about what all this means for the ownership and its importance to future growth however continue. One widely held view is that failure to give full land ownership to the famer has held back agricultural growth. In industry, most authors concur that the 'non-state' sector is doing much better than SOEs. TFP, the famous residual, grew 2–3 times for the private sector than the SOE rate. But equally many have argued that the non-state sector covers a wide variety of 'ownership' rights. The abiding conclusion that can be reached is that "reform of property rights in China has been gradual and limited. Agricultural land remains collective property, only some smaller state enterprises have been privatized and (the most significant) change in industrial ownership is the rise of the TVEs, a form of organization closely connected with local public ownership" (Putterman, ibid).

b. The Chinese state as a developmental force

There are long antecedents of the civil service in China. The traditional Chinese state combined rule by a hereditary ruler with a professional civil service selected in most part through competitive examinations. Apart from creating a functioning bureaucracy, the Chinese civil service had an additional important role, that of promoting a specific political or governing philosophy. An interesting parallel can be drawn with the joining of ideology with the implementation of reforms during the present communist period in China. There are countless references in Chinese history to the test of a ruler being "whether he succeeds in promoting the welfare of the common people" (Nolan, 2004). That a Confucian term, *xiaokang,* is taken on as capturing China's current development vision is no accident and underscores the abiding nature of Chinese culture and reinforces the notion of 'learning from the past'.

Bureaucracy also functions in a specific cultural context. For a long period in China, many aspirants saw the civil service as a path towards personal prosperity and power. The civil service in China acted as a vehicle to

link values and society. It allowed "basic beliefs, operational values and social institutions to be integrated, mutually reinforcing" (Dernberger, 1980) and well embedded in society. The numbers of candidates who passed the exams are staggering. Many more of course took the exam. Even in the 18th century, some 406,000 people passed the local examinations, *shengyuan.* At the higher levels, some 47,500 became eligible to join the civil service (Feuerwerker, 1976). Equally, Confucian precepts contend that if a bureaucracy becomes corrupt, it loses its moral foundation. To serve the people requires winning their trust. And if trust between the people and the government is reduced, social disorder is the likely result, because it reduces the legitimacy of government and 'the mandate of heaven' is removed from the Emperor (or ruling elite). Little wonder that one of the enduring slogans of Mao's period was for the Party to 'serve the people'.

In the more modern period, reform of the civil service dates from 1980, when it was felt that there was a pressing need to "rejuvenate the leadership cadre and the system through which it was selected" (Howell, 2004). Reforms included implementing a fixed tenure system that required retirement for most officials at age 60 for men and 55 for women and efforts to improve the quality of China's leadership, especially by recruiting younger, more educated officials.

Governing a country is as much a 'managerial' task as it is in setting a coherent vision. How was this done in China? The number of top 'managers/leaders' of the country is a relative modest thirty or so. These leaders/managers have to both take national decisions and manage/influence a large number of subordinates. Huang (1998) in his review of the organization of the Chinese government contends that the China managed well in 'aligning' civil servants to the expectations of the leaders. In particular, the Chinese political system was able to deliver on the appropriate mix of incentives and control measures that ensured that the 'right' people were selected to the top levels of the government. This is an important finding for a complex, large country like China, which has 28 ministries and commissions in the State Council, 31 provincial governments, between 2,400 and 2,860 county governments and 30,000 to 40,000 township governments.

In the early 1990s, central party agencies directly appointed a large number of bureaucratic personnel, some 4100 officials, who in turn then oversaw tens of thousands of officials (Burns, 1994). Like business organizations, alignment problems occur when interests of the subordinates deviate from those of the leaders. That China did well in this context goes some distance in explaining how the country was able to achieve and maintain impressive economic and social results despite the enormous constraints presented by a high population and relatively poor resource endowments (Huang, ibid, in his comments on promotion and leadership selection practices).

One notable aspect of the leadership selection practices was the emphasis placed on proven ability and on being tested in a variety of situations. In the 1980s, for instance, the number of provincial bureaucrats who filled key central ministerial positions far exceeded that of ministerial bureaucrats. Two out of three party secretaries in the 1980s had extensive work experience in the provinces. These practices continue to this day. An outlier in this practice is the influential Ministry of Foreign Affairs, which draws its ministers exclusively from its own ranks. Provincial or local level performance was considered critical. It was felt that performance of provincial cadres could be more readily and more objectively measured, and that "the performance of a bureaucrat in a provincial post reveals more information about his suitability as a national leader than the similar performance of a ministerial bureaucrat" (Huang, ibid).

The 1990 reforms of civil service and the public sector were driven in part by the difficulty that central policy makers had in pursing economic reform. Even if many innovations were 'bottom up', with local leaders playing a critical role, reforms themselves when extended nationwide were often watered down, as local leaders were more concerned about coping with the tensions arising from policy implementation. A major shift was in the selection of senior managers from those whose political background was appropriate to work-related abilities and achievement. Performance appraisal of the civil servant in leading positions was further tightened around three broad tasks: economic development, social and spiritual development, and Party building. Due to the CPC's emphasis on economic growth, economic development became the dominant task. Political careers

and bonuses were linked to the achievement of targets. Local leaders in turn could 'sub-contract' the targets to lower level officials (Chou, 2005).

The public sector reforms since the 1980s also strengthened bureaucratic accountability. Accounting and auditing systems were substantially improved and upgraded. Starting in the early 1990s accounting standards were increasingly brought closer to international standards (Narayan and Reid, 2000).

Capacity upgrading has been and continues to be a priority, and education levels of officials have risen continuously over the entire reform period (Howell, 2004). By 1998, nearly 90 percent of bureau chiefs had graduated from university or community college. In 1980, more than 80 percent of provincial/ministerial level officials were 60 years or older. By 1998, this percentage had dropped to about 54 percent (Landry, 2003). Peer feedback of performance, higher levels of education and more recently citizen satisfaction about the provision of social services, all combined to transform the civil service to a development driven service. They resulted in both higher capacity and better alignment with reform objectives, as the younger and better educated cadres were more supportive of the reform process.

The role of the state also evolved during the reform period. During Mao's period the economy was controlled by a centralized political and administrative system. With the start of reform, the state became gradually less involved directly in the economy and the lives of people. New and revamped institutions were created to handle the requirements of law, trade and the market-oriented economy. This did not mean, however, that the role of the state declined, instead it expanded into new areas while still keeping some old functions (Saich, 2003). Unlike most other countries, there is an important separation in the roles of the party and the government, with the Party playing the lead role in setting overall policy and strategy, and the government as the body responsible for its implementing. There is a historical and cultural context here as well. In China there is a longstanding acceptance of an 'active' role of the state, even in earlier periods. Without a strong state capability, it is felt that China would quickly descend into chaos and uncertainty (Nolan, 2004). To maintain its legitimacy, the party launched periodic campaigns to combat corruption and to re-invigorate the commitment of cadres to the supremacy of the party and to 'serving the people'.

There was an important sequencing dimension as well. Early institutional transformation crucially underpinned economic reform, as Deng saw the need to revitalize the bureaucracy as a necessary first step.[21] But this fateful choice did more than that. It both reduced active opposition to the reforms, and created a constituency in favour of change since the newly recruited officials owed their appointments to the leaders promoting change. The sheer scale of the institutional change was staggering. In a short space of time, mostly over 2–3 years, China's bureaucracy was transformed (almost at all levels) as the figures below bring out vividly. By 1988, a remarkable 90 percent of officials above the county-level had been newly appointed after 1982; meanwhile in Russia, by contrast, local leaders remained largely the same people as before reforms.[22] Deng's rejuvenation of the government administration also increased the capacity of officials: the share of governors holding a college degree more than doubled while for ministers the share rose by 40 percent.[23] Very similar results can be seen for provincial party secretaries, mayors and departments chiefs as well as down to county and division levels.

The conclusion is that the Chinese government has both provided a 'supporting hand' in furthering economic growth and was strong enough to direct and guide the different waves of reform. In Russia, the big bang approach left a political/leadership vacuum and a weakened state. One consequence was that the State was captured by powerful interest groups and often functioned as a 'grabbing hand', suffocating growth and development (through corruption, nepotism, etc.). Another was that in many areas in Russia, government presence simply vanished, forcing people to rely on social networks and other informal systems.

[21] Li (1998)

[22] Frye and Shleifer (1997)

[23] The shares rose from 20 percent to 43 percent for governors and 37 percent to 52 percent for ministers, as reported in Li (1998)

4.2.3 SOCIAL CAPITAL (AND SOCIAL COHESION)

- *Social context matters* for the success of reforms. How social conditions are managed and transformed has a large influence on development outcomes.
- *Building a constituency for reform* is a necessary condition for progress. The success of reforms may require according particular attention (and possibly compensation) to those who are potentially losers.
- Social relations *imbedded in informal networks* can help or hurt intended outcomes.
- *Influencing social cohesion and managing disparities* are essential parts of the challenge for development policy.

China has enjoyed strong social cohesion thanks to comparative ethnic homogeneity, historic equality and lack of religious sectarianism. The widespread awareness of the failures of the previous economic policies meant that mindsets were ready for change and engendered buy-in for the reforms. The above made society responsive to reform and new incentives. This responsiveness arguably outweighed market imperfections in promoting rapid growth.

Success of the reforms in the final analysis rests on people themselves, on their attitudes and behaviour. The Chinese reforms demonstrate how reform cannot be viewed as a sequence of decisions by the state to which businesses and individuals respond, but rather unfolds as an organic process of interaction and feedback. In short reform is a process, not an event (Rawski, 1999). The relatively high faith held by people in China in the higher levels of government and in the organizing functions of the political system helped to provide social stability during the reforms. Trust systems offset absence of formal contract enforcement and informal institutions were able to counter the constraints imposed by nascent or imperfect markets (viz. role of *guanxi*, 'friends first, business later').

a. Compensating losers and building constituencies for reform

Reform is rarely painless. There tend to be both potential winners and potential losers. An important component of the Chinese experience has been the limiting and compensation of losers, in effect engendering a reform process that can in large measure be seen as Pareto-improving.[24] Despite the gradual process involved, adjustment was not painless. Large sections of society had to absorb the shock of the reforms. The pressure on society in fact intensified over the years. While average incomes have grown dramatically over the reform period, relative differences are increasingly wide and noticeable, with perceptions of unfairness intensifying over the years as disparities widen.

All or most of the reforms in the first period (1978–92) can be categorized as win-win solutions, from the agricultural contracts (releasing underemployed agricultural labour and raising returns to the farmers who carry on) or the fiscal contracting system (giving local government 100 percent retention at the margin but also providing the centre with increased fiscal uptake) to the buy-outs of the old guard to enable a government generational shift and the dual track production system (maintaining rents and security in the state track while letting private and quasi-private initiative grow in the market track).

The initial rural reforms in particular were a win-win proposition for most parties involved: allowing farmers to retain the profits from all production in excess of their mandated quotas introduced incentives not only to enhance efficiency, but to support the reforms, while the rural bureaucracy was weak, and so reforms were implemented with little opposition. Later industrial reforms similarly introduced strong incentives for enterprises and their managers with profit retention, as well as for local governments through similar arrangements in the fiscal system. Thus several broad constituencies were created who out of their own interest gave their support to reforms, counterbalancing and outweighing the many vested interests that also existed.

[24] Lau, Qian and Roland (2000) and (1997), Naughton (1995)

The fact that lay-offs didn't start until 1993[25] is a good illustration of this. While it was likely partly due to political disagreement among the leadership, it is hard to argue that the strategic implications in reducing disruption were not part of their decision.

Another telling example is the strategy of administrative rejuvenation pushed through by Deng Xiaoping in 1982. Realizing that the path of reform required government officials with different mindsets and skill sets than the typical peasant-revolutionary veterans found throughout the administration, Deng wanted to infuse it with younger and better-educated staff. The problem was of course resistance on the part of those to be replaced, including many in senior decision making positions.

Many observers have pointed out that the dual track system was similarly useful because it improved efficiency while retaining existing economic rents, thus reducing opposition to reforms and allowing the process to move forward without disruption.[26]

It has also been argued that the Chinese institutional innovations were beneficial partly by creating win-win solutions for all or most actors under a complex set of constraints, thereby improving the overall outcome in spite of certain remaining inefficiency – relative to theoretically optimal, but practically infeasible, western institutions.[27]

Not surprisingly, rising disparities have contributed to street protests and demonstrations as workers and farmers seek to convey their frustrations (Blecher, in Howell ed, 2004). A survey of Beijing residents in 2002[28] indicated that 80 percent of those who responded believed that growing income differences were a major social problem. Income inequality has widened substantially. Even more telling than the relative differences captured by the Gini coefficient (which went up from 0.30 in 1978, 0.382 in the late 1980s, to 0.447 in 2000)[29], is the striking gap between rural and urban incomes. In comparing the latter, China has become one of the most unequal societies in the world. In human development terms, life expectancy for rural residents is less than 65 years in Tibet, Guizhou and Yunnan, but more than 74 years in Hainan and Jiangsu. Tibet and Guizhou have HDI levels comparable to countries in Africa, and Shanghai with Portugal. By contrast, for 2000, India has a Gini Coefficient of 0.325, Sweden 0.25 and Brazil 0.591[30].

[25] Gu, 1999

[26] Qian (2002), Naughton (1994)

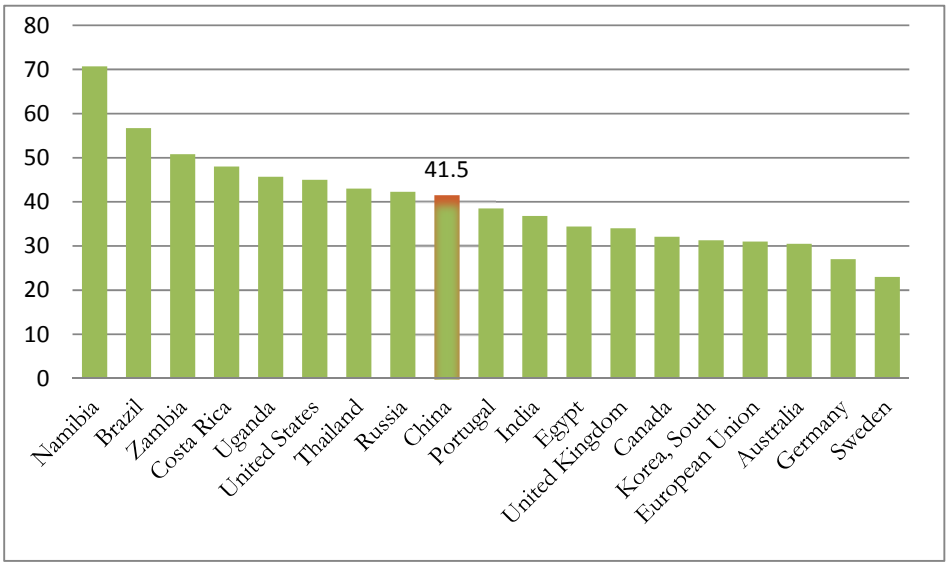
[27] Qian (2002)

[28] By Beijing Social Psychological Research Institute

[29] UNDP China Human Development Report, 2005

[30] UNDP China Human Development Report, 2005, 2007/8

Figure 3: Gini Coefficient in Selected Countries[31]



b. The role of *guanxi* and informal networks

Guanxi is about deepening social relations. It is a longstanding Chinese practice that cultivates mutual interest and benefit. It is also not culturally unique to China. It exists in some form or the other in most societies. Whereas it is associated with corruption by some, in China it generally does not carry negative connotations. Gift giving in particular is seen as a way of deepening *guanxi*. Our interest here in *guanxi* is for a different reason, to see what role it might have played in the conduct of reforms in China. Xin and Pearce (1996) build on the work of Putnam (1993) and Nee (1992) to posit that "managers cultivate personal connections to substitute for reliable government and an established rule of law". Drawing upon interviews with executives in both Chinese state owned and private companies, they draw the conclusion that deepening *gaunxi* was a way to "compensate for (the) lack of formal institutional support". And, as expected, private sector executives relied "significantly more on building connections with government officials to defend themselves against threats like appropriation or extortion (ibid). By this reasoning, with more established systems of market governance, the role of *guanxi* in future Chinese development should decline over time.

In empirical studies at the firm level, Park and Luo (2001) note that *guanxi* makes an observable difference in "establishing external relations and legitimacy and positioning competitively in the market" – more so than in "improving internal operations". Importantly in their study, *guanxi* does not appear to be a significant influence on profits (ibid), even if costs are high in cultivating and maintaining *guanxi*. Their study confirms earlier findings that in a transition economy with ambiguous property rights and weak legal systems, *guanxi* becomes a way to overcome institutional and strategic disadvantages, in particular by developing better links with authorities who have control over resources.

It is possible, however, to take a different, perhaps broader perspective by looking at the positive roles played by *guanxi* in strengthening trust, and how trust is likely to be the 'glue' that enhances business generally, rather than for instance to rely excessively on expensive and conflict oriented legal systems. Guanxi type systems can be viewed as legitimate alternatives to western market systems, since much of the global world values trust in doing business. Lovett et al (1999) consider that the Chinese economy is not just moving towards market capitalism but rather towards a relationship-based 'network capitalism'.

[31] Based on the most recent year of data from CIA World Factbook, see https://www.cia.gov/library/publications/the-world-factbook/fields/2172.html

c. Corruption – how does it function in China?

Corruption tends to occur in two situations: one as an opportunity, especially in situations where state officials have extensive economic and regulatory powers, and second, where there is a motivation brought upon by factors as diverse as relative impoverishment and changing values.

Sun (1999) contrasts the different experiences of corruption in Russia and China, and attempts to answer the question as to why corruption in China has had a less pernicious outcome on economic growth. China's gradual reforms allowed the state to retain control over economic and political decisions and their implementation. Unlike Russia, in China there was no vacuum in the economy that could be filled by mafia-type organizations. The two-track approach also put most of the new opportunities in the non-state sector. What corruptive practices did exist in the non-state sector were directed towards seeking the support of powerful officials or state institutions, so that the 'playing field' was more level. The growing alignment of interests among local officials and private businesses, particularly in the area of real estate,[32] provided strong incentives for public officials to support market outcomes and firm profitability.

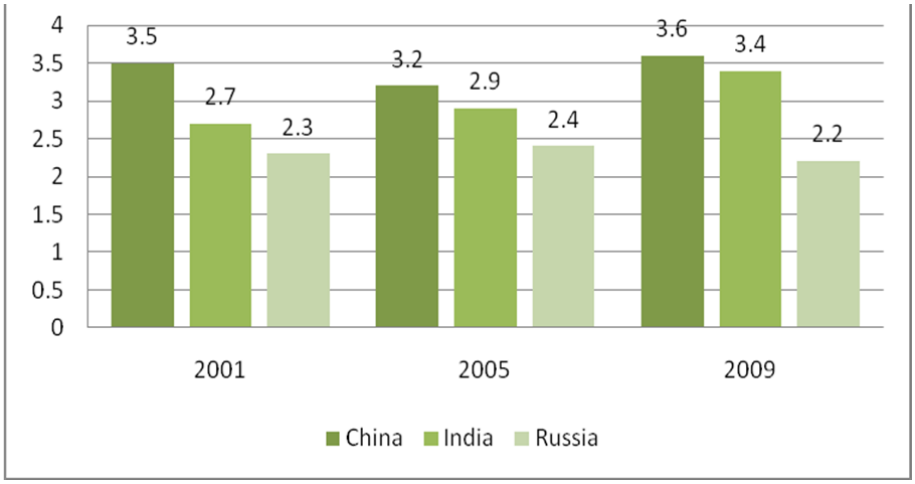
Corruption also reduced opposition to reform. Rent-seeking became the price of institutional stability, "but maybe a necessary price" Sun (1999). Rent-seeking has been the dominant form of corruption in China, with a 20-30 percent premium exercised as a result of the two track system. Between 1987 and 1989 over "70 percent of cadre economic crimes were linked to the two track system" (ibid). With the 1992 financial reforms and curtailment of the range of goods being regulated, the corruptive impact of the two track system also correspondingly declined.

The difference in opportunities and incentives for corruption in China and Russia are linked not only to the reform model pursued but also to the nature of the state itself. The structure of government institutions and the political process are important determinants of levels of corruption. "Weak governments that are unable to control their agencies experience high levels of corruption" (ibid). The Chinese state remained strong, and at the core, its leadership was fairly uncorrupted. Periodic campaigns were conducted to root out corrupt officials, and harsh sentences meted out to those found guilty of corruption. Private sector tycoons were not exempt from state scrutiny, as demonstrated in the imprisonment in 2009 of leading Chinese entrepreneurs including the chairman of Gome, the largest electronics retailer in China.

In 1988, with the creation of the Centre for Reporting Economic Crimes, a vast monitoring system was set up, with local branches nationwide. There is increasing commitment to strengthened transparency in government. Citizen complaints are regularly attended to and income disclosure mechanisms have been instituted across government. Most of these anti-corruption mechanisms were not present in Russia. For senior party leaders and the Party in China, cracking down on corruptive practices has become a necessary part of the arsenal of measures shoring up the legitimacy of the Party itself. It is an interesting statistic that on average two-thirds of crimes in financial institutions are committed by employees under thirty five years of age, with little direct experience of party discipline (Sun, ibid).

[32] which represents an important source of revenue for municipalities

Figure 4 Corruption Comparisons among China, India, and Russiam (higher is better)



Source: Transparency International (2009)

Finally, in an econometric analysis by Iliev and Putterman (2007) of the importance of social capability and related 'soft' factors in the economies of Communist and Post-Communist States, property rights appeared to be at least somewhat more secure and corruption under somewhat better control in China (with a corruption index of 0.30) than in Russia (with a corruption index of 1.01), which they felt might be one factor behind the far larger flow of foreign investment into the former than the latter.

4.3 POLICIES (IN A TRANSFORMATIVE FRAMEWORK)

- *Incentives* are essential to development. *Aligning incentives* to the context and the country's development vision is a crucial task for effective transformation (and growth).
- *Sequencing* matters, a lot. For instance, that bureaucratic reform preceded economic reform in the early 1980s was critical to final success.
- *Social policy* is as important as economic policy for growth
- At times *institutional/organizational reform* is more important for transformation (and thereby growth) than detailed policies.
- Investing in *infrastructure and public goods* generally becomes essential to kick-start broader, sustained growth
- The '*right' policies* may be useless or even harmful in the *'wrong' institutional context.*
- *Macroeconomic policies* should facilitate 'transformation' and growth

There is widespread agreement that the 'right' policy and institutional environments are crucial to fostering economic growth and development. Unfortunately, however, there is equally widespread disagreement about the right policy mix and the most appropriate institutional framework. This disagreement is not necessarily a bad thing; on the contrary, if one believes in ownership and the importance of local context, it arguably serves the interests of developing countries very well that there is no longer a predetermined consensus on specific policies and institutions or their order of introduction

Getting policies 'right' raises an equally important issue of getting 'the policy process right'. Heilmann (2009) considers that the pragmatic nature of policy making in China represents an unusual combination of extensive policy experimentation with long-term policy prioritization, a process which he characterizes as "maximum tinkering under uncertainty". He presents reform in the urban state sector as an instructive example.

Chinese policy makers were well aware from the start that complementary reform packages would be the right way to deal with the administrative and welfare impact of SOE reform. But they could not arrive at a consensus of what the stare sector would look like at the end of the transformation, since sweeping privatization had few supporters. Losing control was an abiding concern. Unlike what occurred during Brezhnev's Soviet Union, this did not produce a policy deadlock, and instead piecemeal restructuring was initiated. In order to deal creatively with uncertainty, political actors of necessity purposefully tinkered with diverse policy measures and institutions, and adapted them to their concrete conditions, thereby finding out what could work at acceptable costs. Observers have likened the management challenges of China's political economy as "rebuilding the ship at sea".

4.3.1 FINDING THE BALANCE: MARKETS AND INCENTIVES

That markets and incentives play a key role has not been debated, rather what appears inadequate are explanations as to why they have worked so well in one context or country and not in the other.

Between 1978 and 2004, in China, the promotion of private business took place in what has been described as a "curbed policy subsystem" by Heilmann (2008). For ideological reasons, private business was one of the least acceptable emerging elements of China's reforming economy. At the beginning it was mostly tolerated as long as it did not pose a major policy risk (Naughton, 2007). The success of the Wenzhou District experimental zone influenced the national debate, even if there were occasional ideological setbacks. A key institutional innovation was the registration of private companies as 'collective' enterprises to conceal the true extent of the private sector, thereby reducing some of the political pitfalls involved in an open promotion of the private sector. Only in 2001 did Jiang Zemin cement the legitimacy of the private sector with the *Three Represents* philosophy that formally allowed socially progressive entrepreneurs to become members of the Communist Party. Private enterprise and private property did not enjoy full legal protection until very late in 2004, almost 25 years after reform first started.

Incentives, however, seemed to work. Reform aimed at decentralizing ownership and control rights, such as decentralizing the right to set wages, to make production decisions, and to appoint new managers, created strong incentives for managers and employees to learn and to work hard. Using an extensive dataset on changes in state-owned enterprises, Xu (1997) found that productivity and growth rates improved significantly with the above incentives. Yet reform measures such as increasing profit retention rates and adopting performance contracts did not appear to have influenced productivity that much. Decentralization alone, for instance, accounted for a large 42 percent of productivity growth in SOEs in the 1980s.

While accepting the unorthodox nature of Chinese policies and reforms, many observers, like Huang (2008), still credit the growing role of markets and incentives as the real drivers of Chinese economic progress. Huang furthers underscores that it is the expansion of private ownership that should be viewed as the primary source of China's economic miracle, that indeed strengthening of property rights and private entrepreneurship provided the real stimulus for high growth. There is some credibility in the latter point about entrepreneurship, though as has been well documented in this book and elsewhere that China's path in developing property rights has been highly specific and unique.

Each wave of reform took a step forward in empowering large numbers of people and providing opportunity and access to markets. The relatively low inequality at the onset of reforms, the first bursts of income growth in the agricultural sector, and the role of the TVEs functioning mostly in rural areas and small towns – all unorthodox in nature – led to the broad-based growth of the Chinese economy in the early years of reform. Inequalities accelerated only later in the 1990s and 2000s. Market forces and entrepreneurship, if not ownership in the traditional sense, have become essential features of the Chinese economy. Over 70 percent of new growth is now contributed by the private sector[33]. Even more, SOEs as well are increasingly functioning within a market environment. Competition is particularly intense for the domestic market between global

[33] Fan, G., 2005. China Is a Private-Sector Economy. Available at: http://www.businessweek.com/magazine/content/05_34/b3948478.htm.

companies and subsidiaries of foreign companies. These are the intended outcomes of specific reforms and opening up policies.

Qian and Xu (1993) in commenting on market performance and the transformative implications of specific policies, compare 'privatization' with 'denationalization of the state' – they point to the importance attached by Chinese officials to enhancing the forces of production, exactly the point underscored by Deng in his explanation about the Four Modernizations. Denationalization covered successful non-state enterprises taking over or merging with state enterprises, converting state enterprises into joint ventures with domestic or foreign non-state enterprises, and reorganization of state enterprises into joint stock companies. In fact, a considerable part of FDI went into heavy industry SOEs. This experience in China is somewhat similar to Taiwan and South Korea (Lau, 1992) where the reduction of the public enterprise sector was achieved mainly through the growth of the private sector, rather than privatization of state enterprises.

While the debate about what drives China's progress is likely to continue, it is worth reiterating that, firstly, most observers accept that China has become a predominantly market-driven economy. It represents a substantial change from where the economy was in 1976, when Mao died. Secondly, observers continue to disagree about what drives Chinese growth. Is it high savings rates? Are the 'animal spirits' of the Chinese responsible as the economy got opened up? And so on. Today most products and services in China are sold at market-determined prices, even if the caveats are equally important. For instance, land remains state property, utility prices are set by the state and so on. Thirdly, markets are very competitive, a consequence of the openness of the economy, with many suppliers and producers competing often at relatively thin profit margins, and a large FDI sector, a phenomenon more important since the 1990s, which produces one-third of the output and is active in both domestic and international markets. Many Chinese prices are converging with international prices. In 2005 imports were equal to 30 percent of GDP, which is high in comparison to Japan (10 percent) and the US (about 17 percent). Equally, China at 25 percent scores high when comparing shares of foreign companies in industrial output in the EU and the US (about one fifth) (Lardy, 2007).

There is a larger role for incentives in transformation. Walder (1995) raises a particularly important point that incentives matter in a more general way for a transition economy, since a society itself is in transformation. Incentives have to be regularly adjusted not merely for individuals and firms but also for government agencies and public officials themselves. But incentives may not be sufficient for successful economic growth. Depending on the specific conditions, more direct support may well be justified so that local producers are not left exclusively to their own devices. Oi (1995) goes on to emphasize that the corporatist strategy pursued in China effectively "spread(s) risks and resources to maximize local community interests", underlining the fact that such an active public-private partnership role of the state was an important ingredient for China's success. Policy options therefore have to go beyond the traditional infrastructural support role, to include market development and promote information and technology.

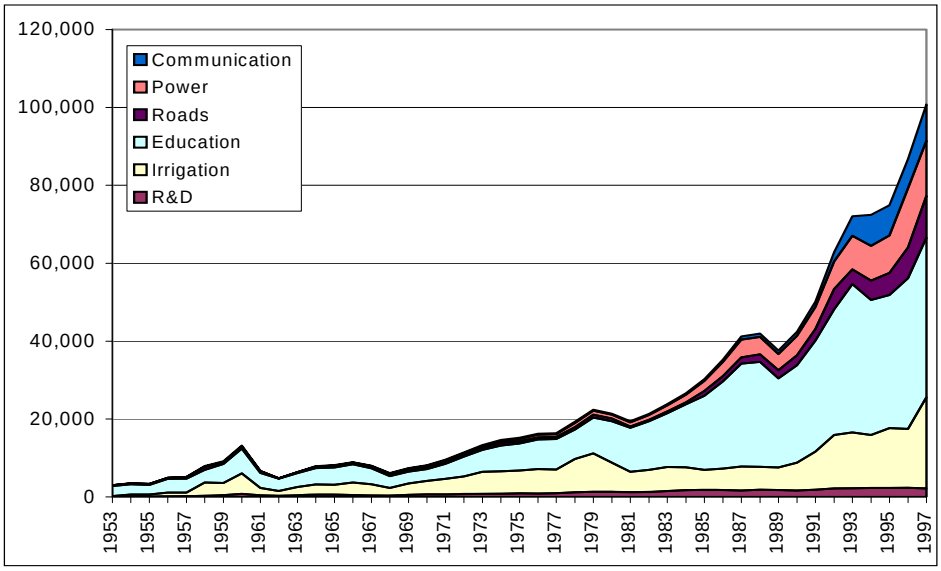
4.3.2 PUBLIC GOODS

Besley and Ghatak (2006) make an important distinction between public goods that support markets and those that augment. The mere existence of public goods does not imply useful provision of government services. Government failure may be as important and as possible as market failure. A basic market-supporting public good is of course the provision of law and order which enable markets to function and 'rights' to be protected. Some legal systems do it better than others. Market-augmenting public goods are closer to what is listed in standard textbooks: they include health and education whose provision can bring benefits to society. Depending on the country and institutional context, infrastructural services such as postal and telecommunication services, rail and air transportation may or may not be provided by the state.

Another way of looking at public goods is to categorise them in terms of their impact on 'transformation'. Building new roads to connect people with markets can have a powerful transforming effect on the lives and incomes of people in the region. Adding an additional lane to an already existing two lane highway may expand trade and commerce but may not have the same transformative value as the earlier example. Similar criteria can be drawn in terms of how pro-poor specific public goods might be (Fan, 2004). The right of access to health

for instance requires a state commitment to ensuring the provision of basic health care, even if the actual provision may require a mix of state and private sector roles.

Figure 5. Public spending in rural China, 1953–97 (Million 1990 Yuan)



Source: Fan et al (2002)

The role of public goods in driving China's transformation was critical. Policy and institutional reforms were combined with massive public investments in roads and other key infrastructures. The rapid economic growth in the early 1980s led to transportation shortages and congestion problems and increased the demand for roads. Responding to these challenges, starting in 1985, the government gave high priority to road development, particularly the construction of high-quality roads such as highways and freeways. While the construction of high-quality roads has taken place at a remarkably rapid pace, the construction of lower-quality and mostly rural roads has been relatively slow.

Using provincial-level data for 1982–99, Fan and Chan-Kang (2005) extend earlier work by Fan et al. (2002) and conclude that road development, together with agricultural R&D, irrigation, education, electricity, and telecommunications, made significant contributions to economic growth and poverty reduction. But, as expected, there were considerable variations in terms of their impact on development for different types of roads and between regions. Low-quality (mostly rural) roads in particular had much higher cost-benefit (four times larger than for high-quality roads). Investment in low-quality roads generates high returns both to agricultural GDP and to rural nonfarm income and is significant in reducing poverty. Another key finding of the study is to present evidence of a potential trade-off between growth and poverty reduction when investing in different parts of China. Road investments yield their highest economic returns in the eastern and central regions of China while their contributions to poverty reduction are greatest in western China (especially the southwest region), implying the need for a differentiated approach to public good investments.

> "Without this essential public good, efficient markets, adequate health care, a diversified rural economy, and sustainable economic growth will remain elusive. Effective development strategies require good infrastructure as their backbone. The enormous benefit of rural roads that the study reveals for China holds true for other countries as well. Investment in rural roads should be a top priority to reduce poverty, maximize the positive effects of other pro-poor investments, and foster broadly distributed economic growth" (Joachim von Braun Director General, IFPRI in his introduction to the above paper).

4.3.3 MACROECONOMIC POLICIES

a. Social policy

If development is about transformation, the role of social policy has to be substantially re-thought. Social policy has to go beyond policies concerned with how society treats the poor and other vulnerable groups, towards the kind of society that a nation wishes to become, and how to influence social attitudes and norms that can facilitate development. Much of the work on social policy focuses on the design of social safety nets, which treat the issue as a matter of protecting the welfare of society's vulnerable groups, hence its treatment as residual nature when talking about budgets. The state can and does influence social norms and practices. One example is in the instances of discriminatory and exclusionary practices linked with race, gender, ethnicity and religion. Social exclusion can be redressed through improving the outreach of public services, for instance by setting up schools and health facilities in rural areas. Stronger forms of such action can be through special policies such as affirmative action (World Development report 2000/2001). Such policies have to become part of the standard tool box of development practitioners and economists. But more than this, social policies can provide for and sustain the conditions for accelerated growth.

Looking at the role of social policy is particularly useful when examining successful transitions of former planned economies to market economies. The former planned economies have much in common with developing countries in this context-except over a shorter time frame, since they realised early on that what they had to do in the end was to transform society, and in that process to develop a new relationship between social norms, development and the state. Fundamentally, this shift required policies and strategies to influence how people interface with their government, and whether a new political culture can be sustained with preferred attributes of greater transparency, representativeness and accountability (Griffin and Khan, 1995).

This broader, society-driven approach affects how we look at traditional policy instruments. Macro-economic policies, for instance are rarely society or 'poor-neutral'. Social policy has to connect with economic policy considerations, bearing in mind that the composition of national budgets is not a value neutral exercise. In particular national budgets have to be assessed in terms of their political and social context. Partly because budgetary matters are seen as technically complex, macroeconomic policies often escape close public scrutiny, despite the reality that these technical decisions have a large impact on people and the progress of nations. Policy conclusions for instance are likely to be very different if expenditures on health and education are seen as investments rather than a matter of social support. Mahbub ul Haq the founder of the UNDP Human Development Reports was fond of stating that budgets were often balanced on the 'backs of the poor'.

The stock of educated people in China has risen in all categories: primary, secondary and junior college and above. By 1980, China had reached a respectable level of over four years of average schooling for the population, a valuable initial condition for the start of reforms. Most empirical studies on China that calculate the effect of education on economic growth do so in terms of wage differences of an educated person, with wages approximating to the marginal product of labour (and hence its contribution to growth). These studies produce a result that education at best contributes around 1 percentage point to the growth rate of China's GDP in the past (Perkins, 2006). That this substantially understates education's contribution to economic growth is equally clear. Most of the models that measure such a contribution are unable to account for externalities inherent in the role of education, as people learn from each other, and the more educated they are the more learning that takes place. It also does not account for its influence on social capital, with education contributing to 'pen to change' attitudes, and a generally positive expectation of future progress.

b. Monetary policy

Since the early 1990s, monetary policies in China have focused on maintaining low inflation and price stability, and promoting economic growth and structural change. In practice the number one objective has been to ensure a minimum growth rate of 8 percent. The second objective was to keep inflation at around 3 percent.

While in theory there might be short-term trade-offs between the two objectives, authorities saw the two objectives as mutually reinforcing in the long run. Growth has been accompanied by low inflation in China. The third objective has been to maintain stability of the exchange rate. The peg of the RMB to the US dollar,

and now more recently to a basket of currencies, has been an effective tool for some time now in maintaining such stability. Recent capital liberalization and the appreciation of the RMB to the dollar for the 2004-8 period has made monetary policy more challenging to reconcile these different objectives.

Relatively simple macroeconomic rules were followed: Evidence suggests that when the growth rate is above 10 percent, Chinese authorities accelerate their 'cooling' efforts without waiting for inflation to accelerate. Conversely, when the economy is in a downturn, i.e. growth rates less than 8 percent, authorities adopt expansionary policies to stimulate the economy. There were situations however where it was quite difficult for the authorities to make the right call. If growth rates dropped to 9 percent where inflation rates were still high, decision makers had considerable difficulty in judging whether the inflation rate would fall further, without the further tightening of macroeconomic policy. Inflationary concerns were addressed through direct, often administrative action as well on the supply side. An example can be highlighted: In 1997, when the growth rate was dropping and overcapacity was clearly visible, authorities were reluctant to simulate the economy, as they were concerned about inflationary resurgence. Only when it was already too late was the action taken to shift the earlier contractionary policy to an expansionary one. This was one of the factors that led to a slowdown in growth as well as to a six-year period of price deflation (Yu, 2008).

In managing inflationary pressures, the Chinese government employed a range of measures, not just monetary policy. A case in point is its response to the soaring food prices in 2008, when China's consumer price index (CPI) hit a 12-year high with food price changes accounting for much of that increase (almost 80 percent).[34] China implemented a system whereby provincial governors assumed responsibility for the grain supply programme, and city mayors for the non-staple food supply[35]. Meanwhile, grain stocks were released, export subsidies were cancelled, and export levies were assessed. Furthermore, exports of food and feed commodities were not to be allowed at all till that winter in 2008 (Yang et al. 2008). Most of the actions taken were administrative in nature.

A consistently expansionary policy can have other risks. However a quick review of China's debt accumulation history during the last 10 years of an expansionary fiscal policy shows that China's debt/GDP ratio has remained generally less than 20 percent. Many economists (Hoffman and Wu, 2009) have argued that if we take into consideration the so-called contingent liabilities, China's debt/GDP ratio is much higher, maybe as high as 100 percent. But these fears may not be entirely warranted as long as certain assumptions hold. Yu (ibid) notes: "the Chinese government's ability to repay debts is much higher than it appears. … As long as China can maintain a relatively high growth rate of 7-8 percent, and a budget deficit/GDP ratio of less than 3 percent, following the passage of time, the debt balance/GDP ratio would converge to a limit of less than 40 percent."

c. Fiscal policy

China's extraordinary progress is connected to the role public finances have played in the arsenal of policy measures. Fiscal policy has played and continues to have a significant influence on China's economy and society. Indeed, as the economy grew, so did the state's ability to invest further in the economy and society.

Over the years, there have been large ebbs and flows in the relationship between national income and revenue, some which are difficult to fully understand when comparing it with international experience. "In the first 17 years the revenue/income ratio dropped by almost 21 percentage points from 31 percent in 1978 to 11 percent in 1995. The subsequent 9 years to 2004 saw a close to 9 percent rise. The magnitudes of both the rise and fall are huge by international standards and have gone together with a fundamental transformation of the economy" (Hussain and Stern, 2006). In part this reflected the many waves of reform which required

[34] China's CPI hits 12-year high over soaring food prices. Xinhua News. 11 May, 2008. Available at: http://news.xinhuanet.com/english/2008-03/11/content_7763862_1.htm .

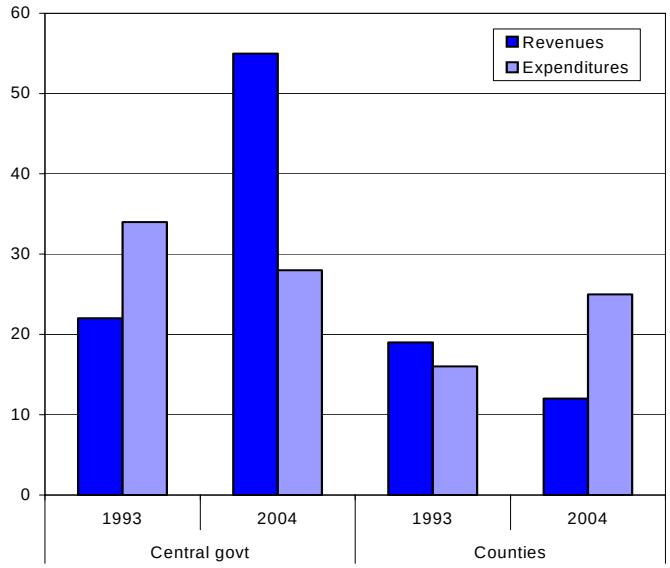
[35] Premier: governors, mayors responsible for "rice bags," "vegetable baskets". Xinhua News, 3 May, 2008. Available at: http://news.xinhuanet.com/english/2008-03/05/content_7721024.htm.

different levels of fiscal support. Yet in all of this, reflecting their sense of fiscal probity, Chinese leaders have kept deficits generally low – only in a few years did they reach 3 percent of GDP.

In the early years of reform, with price liberalization and the rise of private sector firms, the tax base gradually reduced. This was coupled with an intergovernmental fiscal system that provided incentives to local governments to grow but encouraged them to use fund transfers as 'extra-budgetary funds' often outside the purview of the central government. "By the mid-1990s general government revenues had fallen to 11 percent of GDP (down from more than 31 percent in 1978) and the central government share of these revenues had dropped below 30 percent. Meanwhile, extra-budgetary funds had become as large as budgetary funds. Although budget deficits remained small, quasi-fiscal operations through the banking system were substantial, about 5 to 7 percent of GDP" (Hoffman and Wu, 2009).

The 1994 financial sector reforms were important in that they tried to reverse the situation: they led to a gradual increase in the share of government revenues in GDP (20 percent of GDP in 2009), and an increase as well in the central government share of those revenues from less than 30 percent in1991to almost 55 percent in 2002.

Figure 6: The fiscal capacity of central and local government

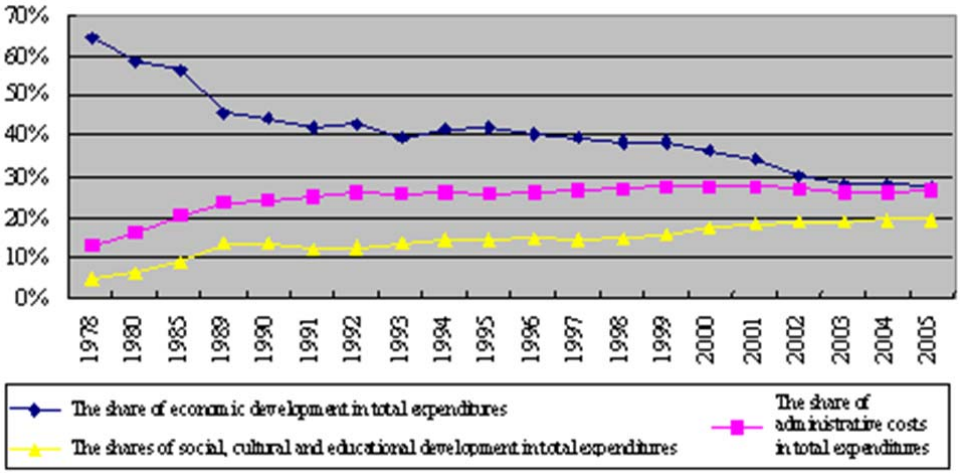


Source: National Bureau of Statistics of China

China's government expenditures were concentrated on building infrastructure, reforming state-owned enterprises, developing the social security system, science and technology, education, agriculture and development of the western regions. A virtuous cycle can be noted. The growth in overall income and a stronger tax collection effort led to rapid increases in tax revenues relative to the increase in interest payments. Interestingly enough, it appears that the result of a long-term expansionary fiscal policy has been an improvement rather than deterioration of China's fiscal position (Yu, 2001).

Figure 7 also brings out some of the structural changes in the state's fiscal expenditures. Particularly noteworthy is the relatively high shares of economic development in terms of total expenditures for much of the reform period. Only after 2002 did this share drop below 30 percent. Correspondingly, the state increased its expenditures over the years on social, cultural and educational development.

Figure 7: Structural changes in the state's fiscal expenditures (1978–2005)



Source: UNDP China HDR 2007–2008

At the start of the 1994, financial reforms, provinces "collected most of the taxes but the central government was responsible for close to half of the expenditure", clearly an unsustainable situation (Hussain and Stern, 2006). With the far reaching 1994 financial reforms, this pattern was reversed. The central government now "raises over half of tax revenue but is responsible for only 28 percent of the total expenditure" (ibid).

Many observers like Hussain and Stern (ibid) contend that fiscal reform has not been rapid enough, the banking sector remains weak, and that it has lagged behind market reform. Others like Brean (1998) provide an interesting counterfactual by contending that had this been done with corresponding pressure on inefficient SOEs, China would have faced untold social and economic instability. China took on financial reform with a close eye to progress on the real economic front.

Administrative measures as opposed to more indirect measures remain important, for instance in 2004 and 2006 in guiding investment demand and in the management of China's exchange rate policy, though in recent years in China there is growing recognition and some progress of the need to move deeper fiscal reform. The central government can potentially play a larger role in dealing with regional inequalities, as it is now in a better position than before in redistributing resources from richer to poorer regions. For a variety of reasons, especially given the growing concern about inequalities, leaders recognize that, as in the earlier decades of reform, fiscal policy has a crucial role to play in generating the improvements in social services such as health, education and social protection, and in providing stronger support to migrants who now struggle to access social services due to the *hukou* restrictions, and in building a more just and harmonious *xiaokang* society.

4.3.4 INNOVATIVE BUSINESS MODELS (AND PUBLIC PRIVATE PARTNERSHIPS)

In China, local governments in particular played an active role in supporting TVEs, though their specific contribution to the development of such organizational capital remains debatable. TVEs in some ways fused local government to entrepreneurial action.

Can states directly influence the creation of organizational capital? Walder (1995) argues that a combination of decentralization, opening of economic space for local commercial action and the involvement of local bureaucrats in business created in effect a 'local-corporatist state' working under hard-budget constraints. Without entering into the debate about the usefulness of such a term, especially when extending the underlying logic of Walder's approach to the urban decentralized industrial state sector (Nee et al, 2007), fiscal decentralization in the early 1980s did serve to harden local governments' budget constraints. Generally, governmental support by definition tends to be about 'soft budget constraints' as there is always a bailout

guarantee through higher level governments, extra-budgetary fees, tax increases and public debt. However a federal system in China in effect created incentives for competition among provinces and counties for mobile capital and labour resources. Local governments responded by providing a competitive local infrastructure and business environment (Qian and Roland, 1998). Bailout of inefficient firms became in a sense unattractive.

Yet it is difficult to go further than that and claim that local authorities directly and successfully added to organizational capital at the firm level. All governments have multiple political, economic and social objectives. In China, at different stages of reform, both the incentive for public officials to be directly engaged in commercial work and the outcomes have varied. In rural China, in the initial stages of reform, for instance, land was distributed directly to the farmers tilling the land. This form of limited privatization benefited the direct producers fairly equally. It led to rural, small households taking the lead in the expansion of the private non-agricultural sector. Walder (2002) claims that the reason ordinary households benefited disproportionately from such reforms is that the rural administrative elite (officials) had more attractive alternatives with good salaries in their government positions and potential managerial positions in the expanding public enterprise sector. State capture was limited. The government elite and their relatives avoided movement into private enterprise, while private entrepreneurs avoided – or were excluded from – movement into the government posts. A different situation obtained in the 1990s, when "rural governments began to privatize their public firms…the implications of privatization shifted rapidly, as the managers of public enterprises and the relatives of cadres moved into private enterprise at rates higher than all others. When they did so, they began with assets much larger than those held by the household entrepreneurs who pioneered the rural private sector. In short, the social impact of privatization shifted as the process changed qualitatively through time, and the benefits shifted decisively from ordinary households to rural administrative elites" (Walder, ibid).

Potential conflicts of interest between firms and public officials are also well documented in China. "Conflicts of interest, for instance, emerge in the cases of firm extensions across community boundaries, shifts of production sites and the downsizing of firm employment. In each of these cases, the goals to maximize local revenues and wage labour naturally collide with a firm's objective of profit maximization. Also frequent extension of government help in case of labour unrest and local demonstrations, confirms that governments never act independently of non-economic goals, so long as they wish to secure broad social consensus. Finally, the capability of government officials to act as entrepreneurs hinges on the solution of the asymmetric information problem between principal and agent. In other words, we suspect it is the state bureaucracy's capacity to set up and maintain an institutional environment that offers conditions favorable to private capital that explains the success of a developmental state in promoting transformative economic growth" (Nee et al, 2007).

Other terms have been used as well to describe the nature of this public-private partnership at the local level in China. Zheng (1994) refers to 'developmental localism', and Oi (1995) suggests a model of 'local corporatism', which under the particular circumstances – including important information asymmetries and unfair advantages in the form of soft credit, subsidies and guaranteed markets that public enterprises enjoyed – was more efficient than purely private forms of ownership would have been in promoting economic growth, especially in a transition environment that early-reform China represented. Young (2000) however considers this as local protectionism with its attendant costs. Whatever the term, what is clear is that, headed by local governments, this model led to a massive upsurge of a hybrid rural industry (TVEs) on the edges of agriculture and state industry. Local officials were directly engaged in encouraging and ensuring the success of these enterprises. Much of the production during the early stages of reform required little expertise and start up costs, entry barriers were low. This may explain "why China has been able to pursue a development strategy without an elite central bureaucracy of the type that exist(ed) in Japan and Singapore" (ibid).

4.3.5 THE CHINESE DIASPORA AND FDI

The importance of the Chinese diaspora in Southeast Asia, described by political scientist Gordon C. K. Cheung (Cheung, 2004) as a 'virtual nation', wherein economic as well as social capital flow in broadly based regional and increasingly global networks. Kao (1993) considers the size of the Chinese business located outside the PRC as the world's fourth economic power, after the US, Europe and Japan. It is a "network of entrepreneurial relationships" that share a common culture (ibid).

This diaspora has played an important role in China's development, in at least two ways: as a provider of capital for a country strapped of such resources in the early years of reforms, and second in helping upgrade skills and methodologies that enabled the Chinese economy to catch up in a relatively short period with global product standards, technology and innovation. They also introduced new business models that allowed China to leapfrog traditional approaches to business plan development and fixed capital constraints. For instance, Li Ka-shing the richest man in Asia convinced Deng Xiaoping in building a bridge across the Hongkong straits linking the island to the mainland financed upfront by HK money, with the investment recovered over the years through toll taxes or other revenue generation schemes. Once the model demonstrated its usefulness, thousands of bridges and highways were built using the same model. Similar innovation has characterized the recent dramatic spike in Chinese investment, both public and private, in areas like Africa and elsewhere. Chinese companies are agile and able to draw on extensive national and international Chinese networks. Chinese companies depend less on data and feasibility studies than on intuition, party guidance and a firm grasp of the technical aspects of the planned investment (Chen, 2001).

The Chinese diaspora was responsible for much of the early FDI flows coming into China. FDI flows from the ASEAN (essentially from five countries – Philippines, Thailand, Malaysia, Singapore and Indonesia) accounted for a peak of almost $ 11 billion in 1995, and were still over $ 3 billion annually during 2000/2001. The Chinese diaspora were among the first investors that took the risk and responded almost immediately to China's open-door policy (Shambaugh, 1995), with initial investments in the four special economic zones: Shenzhen, Zhuhai, Shantou and Xiamen. Ethnic ties served as a lubricant for the strengthening of social relations and networks that encouraged investments in the mainland from the Chinese diaspora[36]. . Yet, however dense social ties are, they do not substitute for managerial competence or technological learning, this form of social capital plays a role of supplementing more traditional forms of capital and know-how. "In this context effective guanxi plays the role of lubricant which enhances the transaction, not the glue which fixes the transaction" (from Smart and Hsu, 2004).

The role of FDI in Chinese development is not without some controversy. Huang (2003) sees the high levels of FDI more a reflection of China's weakness as an economy rather than its strength. Foreign firms play a large role in the economy not because all of the foreign firms are:

> "the world's best practice forms but because they are uniquely positioned to exploit many of the business opportunities in China created by China's inefficient economic and financial institutions" (Huang, ibid)

However, it is difficult to contest that organizationally and in terms of product standards, Chinese firms and the Chinese economy generally were quite far off from the competitive standards of the global economy. Crucially, these early FDI flows provided information about world market conditions and the expertise and contacts so vital particularly for export markets (Smart and Hsu, 2004). They linked mainland firms to global networks and helped them understand the implication of quality and product standards. Even Huang accepts that the early deficits in rule of law and lack of properly functioning markets in China would have deterred most foreign firms from entering China's "murky business environment" (Smart and Hsu, ibid). The outlier of course was investment from the Chinese diaspora, who were willing to take risks for a variety of reasons, including the sense of ethnicity and a desire to help China in its emergence as a trading and manufacturing power. This was not the only difference between Chinese diaspora FDI and non-Chinese transnational (TNC)

[36] Most Chinese diaspora in Southeast Asia are from Fujian, Hakka, Chaozhou and Guangdong

FDI. Western TNCs were generally larger in firm size and tended to invest in the big cities, whereas Hong Kong and Taiwanese investors were open to investing in the countryside, though transportation linkages remained important since many of their investments were in the export sector.

In summary, overseas Chinese capital played a key role in China's linking up to the global economy and in being a source of much needed capital especially in the early years of reform.

4.4 SEQUENCING REFORMS: POLICIES, INSTITUTIONS AND CAPACITIES

Institutions and policies are profoundly joined at the hip. One cannot succeed without the other. Yet, there are interesting questions of sequencing which China's experience brings out forcefully. Without committed people with the right attitudes, policies themselves may stand little chance of having the intended impact. Deng's decision to revamp the government administration very early in the reform process arguably laid the foundations for the remaining changes the ruling elite intended to introduce. By removing those of the old guard who could be expected to object on political grounds to his policy direction and who were often peasant revolutionaries with low levels of modern education, Deng created a younger, more open and better educated government bureaucracy both more likely and more able to support him and like minded leaders in the new course for China.

In turn, opening up markets has for instance created in China an 'effective' demand for stronger, more transparent rules and better regulatory institutions. In the first phase of China's reforms getting the fundamental institutional setting right through profound structural change mattered more than specific policies, given the need for workable solutions to a radically different mode of production. The 'right' policies may be useless or even harmful in the 'wrong' institutional context. In the later period, getting policies right has come of increasing importance as the institutional framework has matured. As many have recognized, the current resource intensive growth pattern has become increasingly expensive to maintain. In order to raise the efficiency of production, China now has a challenge to get both policies and institutions aligned and 'right'.

5. Conclusion: Connecting the dots…. of transformation lessons

> "In severe crises, growth rates achieved in the past do not preserve stability. Short-term government rescue schemes cannot compensate for social inequality and social tension that has accumulated over decades" Heilmann (2009)

> "The past does not guarantee the future". Chinese proverb

This paper presents a transformation storyline of China's development since reform and opening up began in the late 1970s. By doing so, it attempts to highlight narratives and lessons that can help decision makers and development practitioners from other developing countries. Lessons are 'transportable' only in the sense of knowledge sharing and understanding of specific development situations.

It is clear that there can be no simple policy prescriptions or lessons. The hard work has to be done by national leaders, elites and institutions themselves; hence the importance of national ownership. They can draw upon the lessons learnt from other development experiences, successful or otherwise, and craft home-grown solutions. Investing only in education at the expense of a growing economy is a process that is likely not to be sustainable. Markets and incentives are important if people are to realize their productive potential; but if their access and ability to participate is limited, then that as well will become part of the challenges that policies have to address. Low productivity in agriculture combined with poor roads and infrastructure is unlikely to lift famers out of poverty. And reducing barriers to developing country imports endemic in global markets has to become part of the enabling framework for developing countries to make progress. Simply opening up their economies to the outside world by itself is unlikely to help developing countries necessarily benefit from globalization. "Even if (their) GDP increases, the growth may not be sustainable, or sustained. And even if growth is sustained, most of (their) people may find themselves worse off" (Stiglitz, 2006).

It is clear that history and institutions matter. So do capacities and policies. It is the mix of all these that produces specific development outcomes. Sustaining these development outcomes requires committed leadership and a coherent long-term vision. While some of these factors can arguably be seen as given, such as geography and resource endowments, this paper has posited that, as China's experience demonstrates, there are a few issues that are not amenable to policy or committed reform – that it is, for instance, possible to set up systems and incentives that encourage people to work hard and prosper, and for the government to become an active agent of change.

In China, as has been well documented, initial conditions were favorable in several key respects at the start of the reforms: human capabilities were relatively high, there was a relatively equal distribution of income and wealth – Mao's reforms in the 1950s and 60s had dramatically swept aside the inequities of the past, and leaders and the people were both ready for change, mostly a result of the failed policies of the earlier periods, particularly the long, difficult experience of the Cultural Revolution. All these factors combined to create a 'great pragmatism' among Chinese leaders and people alike. These were important strengths. In the economic sphere, there was little external debt, due to the austerities practiced during Mao's period. Whyte (1995) also considers that China emerged from collectivization with a much higher capacity for small-scale rural entrepreneurship. Others like Oi (1995) are of the opinion that that Mao political system had a strong administrative strength that was available to later leaders when pro-growth reforms and policies were adopted. However, it bears repetition that not all this was a result of past historical conditions. For instance, the development orientation of the bureaucracy was the intended result of the administrative reforms introduced by Deng Xiao Ping and his government.

The role of the state was particularly decisive. There was a signal move towards merit and ability in bureaucratic career patterns and a generational shift in the bureaucracy. The evaluation system for party officials strongly encouraged growth. Not only did the state function as a 'helping hand', but through extensive decentralization and an emphasis on results, there were incentives for strong public/private partnerships at the local level, giving rise to terms like 'local corporatist state' to capture the phenomenon whereby private and quasi-private firms were actively supported by local authorities. This active support was supplemented by equally active efforts to 'grow the market', with orders from the different parts of the state providing the first basis of entering a market. Hybrid forms like TVEs prospered and drove Chinese development, particularly in rural areas, for much of the 1980s and the 1990s. But in time these forms were recast or reinvented into new corporate arrangements, at times with FDI investment, to become more competitive and to benefit from the increasingly market driven environment.

In the broad sweep of Chinese reforms, there was particular interest in introducing new incentives that influenced behaviour of all different segments of society: consumers and producers of course, but also government officials, managers of public enterprises and private entrepreneurs. Conscious policies were directed to deepen competitive pressures and the role of the market in wide areas of the economy. Public ownership was maintained, but successive waves of reforms ensured that SOEs also had to perform in the market, and operate under increasingly 'hard' budget constraints.

With the large and rapidly growing rural economy in the 1980s and 1990s, incentives for government cadres were created as well to share in the prosperity from growth. Their interests were not confined to public ownership. The rapid growth in the private sector created opportunities for them as well, and later 'privatization' or 'restructuring' of public enterprises such as TVEs near the end of the second decade of reform, created additional opportunities. "A large new class of independent entrepreneurs now dwarfs those with political connections and rivals them in wealth. We have also seen that asset-stripping in this setting has been restricted and delayed due to the continued viability of the party-state, and that to the extent that it does occur, it is a gradual process that will take place over a generation or more" Walder (2003).

The 1994 reforms of the fiscal and intergovernmental fiscal system gradually increased the share of government revenues in GDP (to about 20 percent of GDP now), and also increased the central government share of those revenues from less than 30 to almost 60 percent. Like other developing countries, some of the

elements of China's success appear the standard ones: liberalization of the price system, opening up for trade and foreign investment, commercialization of the financial sector, privatization of the economy – all while maintaining a reasonable level of macroeconomic stability. However, the way in which China pursued these reforms has been radically different from most other developing economies: it pursued reforms in a gradual, experimental way, by using decentralization and incentives to reform local governments and to provide time and space for people's attitudes to adjust to new expectations. Importantly, and again consciously, it undertook measures to ensure that change to the extent possible was a win-win proposition for most segments of the population. Maintaining and protecting social cohesion was a high priority.

China also grew rapidly because it was able to sustain its reforms over long periods of time. Even when confronted with challenges such as the Tiananmen Square incident, it responded by deepening reforming. Other countries' reform processes saw more swings in the pendulum, in part driven by the political cycle inherent in the short-term nature of most elected governments. Above all, China was able to develop domestic capacity to design and drive home-grown reforms suited to its conditions.

Even in the early period of reforms, China was able to raise the finance needed for its capital-intensive growth, through use of creative business models and in close partnership with overseas Chinese capital. A closed capital account and increasingly strong banking supervision reduced the risks of potential financial crises, a lesson that China learnt well from the Asian financial crisis in the 1990s, when open capital accounts devastated domestic economies of many Asian economies with the flight of global capital flows away from those countries.

And despite journalistic accounts to the contrary, China has pursued a determined effort to reduce corruption in government and society; it has avoided capture and concentration of power by building institutions within the party and government that have in the large part put a check on power abuse and corruption. Equally, encouraged by a decentralized, federalist environment, the active competition among regions has tended to limit opportunities of rent seeking and encouraged institutional innovation.

Not all policies and reforms were of course helpful. Many of the emerging challenges have arisen in part due to the rapid growth itself. Concerns about sustainability are dominating official debates on new policies and reforms. What are China's prospects for the future? Will growth continue? What are the transformative forces in play and so on? As China grows richer and policy objectives are no longer exclusively about growth, what are the likely policy trade-offs of efforts to ensure that the benefits of reforms are spread more equitably? These essential questions occupy leaders and policy makers alike in China. Their commitment to reform and to moving the country forward in its modernization drive remains, however, as China seeks to quadruple per-capita income levels by 2020 (compared to 2000).

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