

TAKING STOCK: WHAT CHINA HAS DONE RIGHT

Paul Deng
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What China has done right

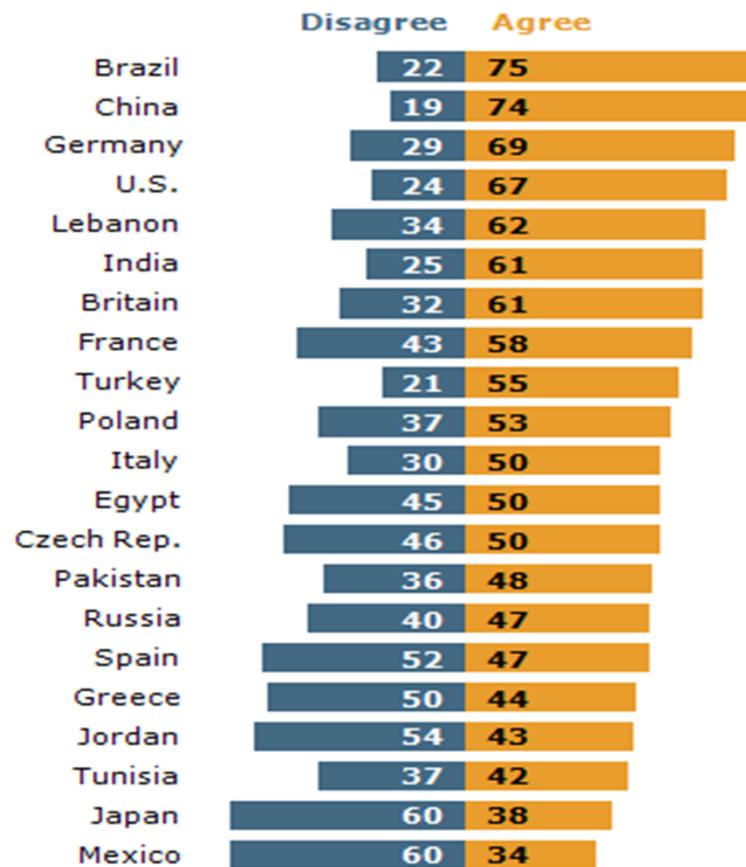
- So far, we have discussed three pillars of China's growth story since 1978:
 - freeing rural labor from collective farming, and allowing them to move relatively freely, although still with limits;
 - restructuring of SOEs, incl. privatization and securitization;
 - “open-door” policies in both trade and FDI

What China has done right

- But underlying all three pillars are ***institutional changes and innovations*** that suited China's unique situation
- *Institutions are rules of the game that shape people's incentives*
- The improved institutions, though still far from perfect, removed many distorted incentives, making people want to work harder and excel in society
 - Deng Xiaoping's famous quote, "***To get rich is glorious***"
- Getting incentives right has been the fundamental driver and common theme throughout China's three-decade economic reform
 - What Chinese have learned is really very simple, "It's the incentive, stupid!"

This sentiment was reflected in public poll

Are People Better Off in Free Market Economy?

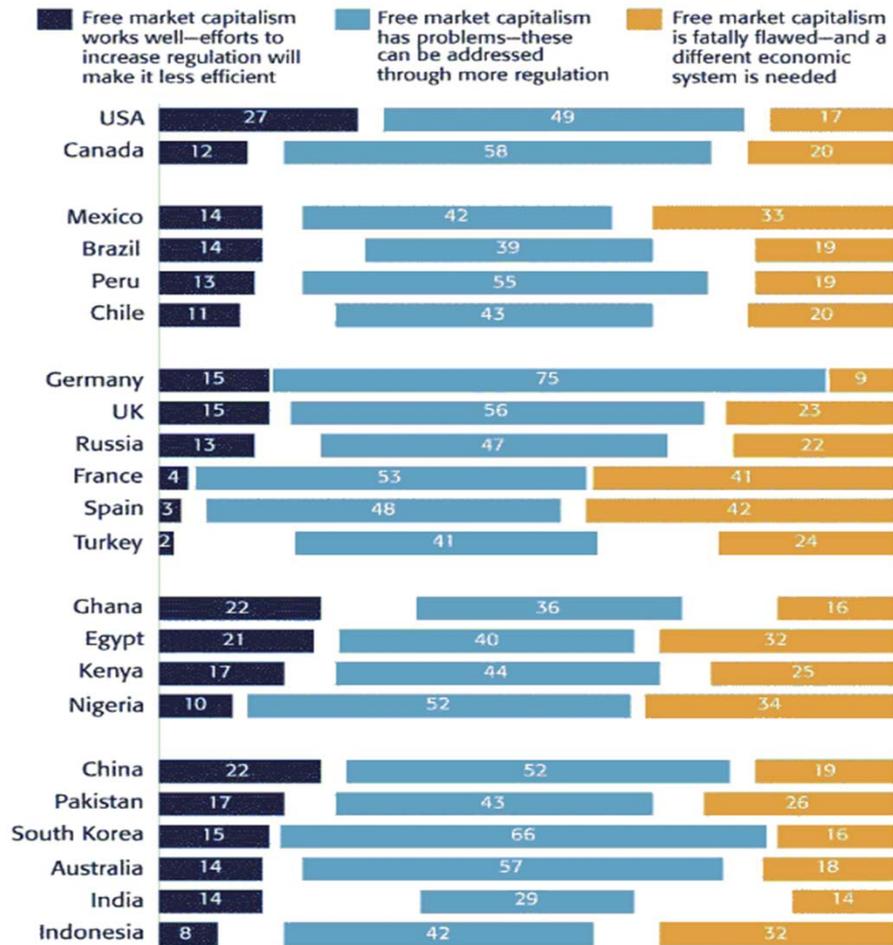


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Public opinion in more details

Views on Free Market Capitalism

By Country, 2012



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The white space in this chart represents "Depends" and "DK/NA."

China: hardly a Communist state today

Most People Better Off in Free Market Economy

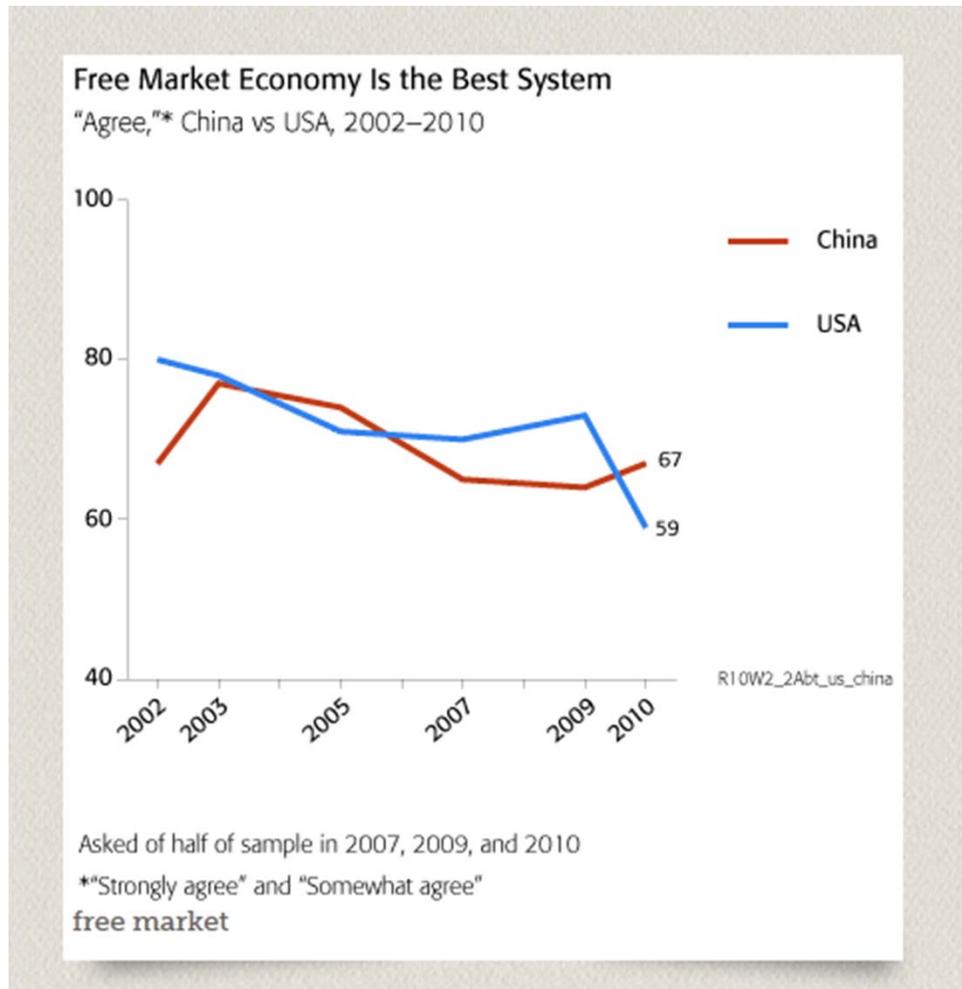
% Completely/mostly agree

	2002	2007	2009	2010	2012	07-12 Change
	%	%	%	%	%	
U.S.	72	70	76	68	67	-3
Italy	71	73	75*	--	50	-23
Spain	--	67	57	62	47	-20
Poland	44	68	65	68	53	-15
Britain	66	72	66	64	61	-11
Czech Rep.	62	59	63*	--	50	-9
France	61	56	57	67	58	+2
Germany	69	65	61	73	69	+4
Greece	--	--	--	--	44	--
Russia	45	53	51	60	47	-6
Lebanon	76	74	64	60	62	-12
Pakistan	50	60	65	57	48	-12
Turkey	60	60	60	64	55	-5
Jordan	47	47	54	48	43	-4
Egypt	--	50	60	51	50	0
Tunisia	--	--	--	--	42	--
Japan	43	49	41	43	38	-11
China	70	75	79	84	74	-1
India	--	--	--	--	61	--
Brazil	--	--	--	75	75	--
Mexico	--	--	52	44	34	--

* Data from Fall 2009 survey.

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This is really interesting...



Wow! The chart seems to suggest that Chinese believe in capitalism more than the “hardcore” Americans

But wait a minute...

- Isn't China still ruled by the Communist Party – the largest political party in the world that boasts over 80 million members?
- Isn't Chinese government still playing a huge role in Chinese economy today? – Just think about the banking system
- How come a communist party could have initiated reforms that embraced many principles of capitalism?

So, how to reconcile these contradictions??



Chinese Communist Party Today

- Chinese leaders today are characterized by their **pragmatism**, a fundamental shift from being ideological in Mao's era
 - During initial years of reform, there were many heated debates regarding “socialism vs. capitalism”, but no more
 - Again, Deng's another famous comment, “It doesn't matter whether it is a yellow cat or a black cat, ***a cat that catches mice is a good cat.***”
- Inside CCP, opinions are very diverse behind the official party line
- After the collapse of Soviet Bloc in early 1990s, CCP constantly feels pressure to survive. CCP's legitimacy to rule hinges on their ability to provide fast economic growth and better living standards for its people
- Naturally, CCP and Chinese government tend to be ***pro-growth and pro-stability***

The Role of Government

- No doubt, Chinese government has played, and is still playing a big role in Chinese economy today
- But try to take a look at how things have evolved in the time dimension, i.e., taking an evolutionary perspective:
 - government today has much smaller role than when the reform first started
 - For example: SOE's role in the economy
 - Public opinions also reflect such shift

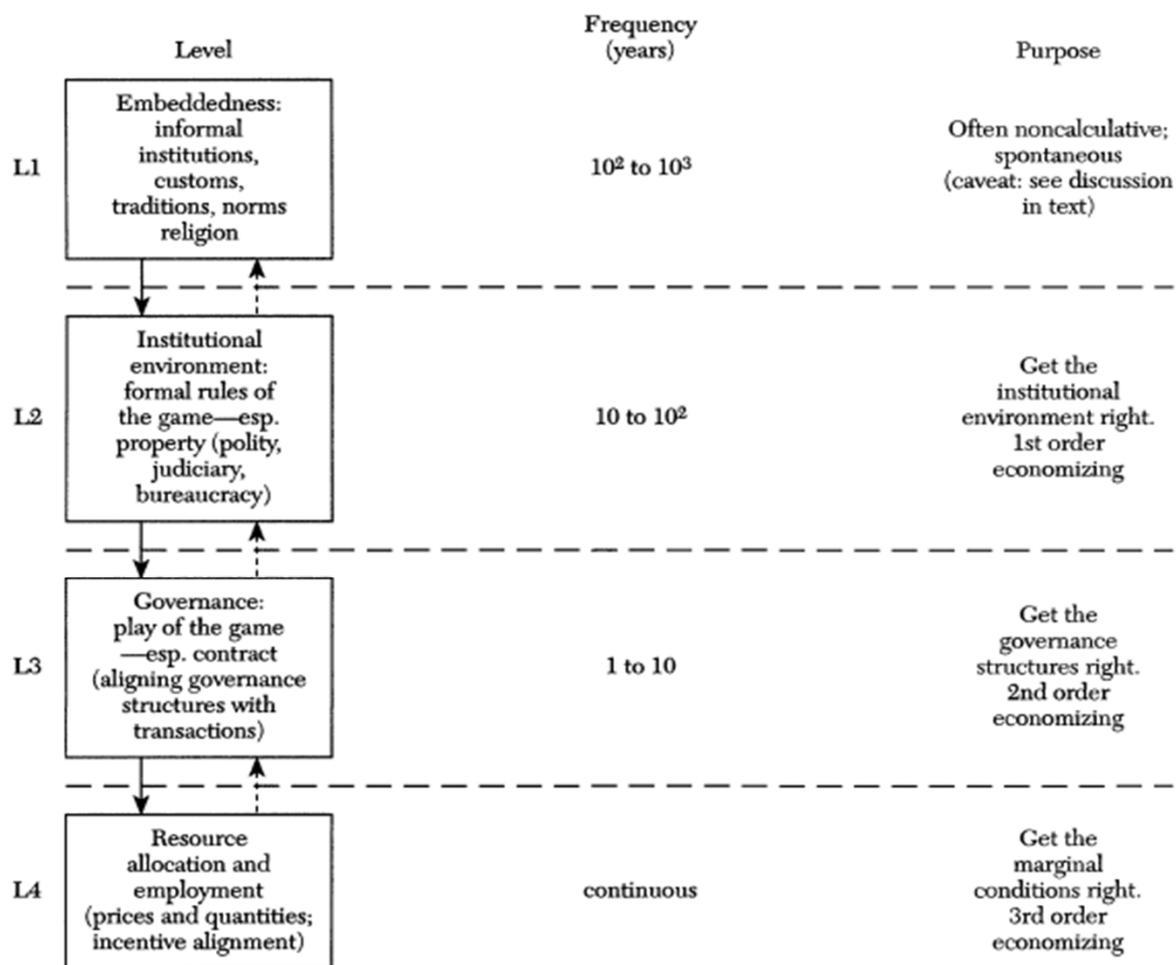
The Role of Government

- Lastly, bear in mind that China is a huge country: it has always remained ***de facto decentralized***, despite various centralization efforts in history
 - Famous Chinese saying, “天高皇帝远” (*sky is high; emperors are far away*)
 - A good example: farmers experimented private farming during the heyday of collective farming
- China’s different regions and local governments also have their own priorities and agendas, which may run into conflict with central government
 - Federalism, Chinese style
 - Compared to the US federalism, Chinese “federalism” is, however, much more centralized

The Gradualist Approach to Reform

- Gradualism vs. the Big Bang
 - Gradualist approach: China
 - Big Bang approach: Russia, Poland, and other East European countries
- China's adoption of gradualism was a combined result of
 - CCP's being cautious and stability concern;
 - lack of blueprint for the reform: started with goals to improve *socialist superiority*, but ended up being more like capitalism;
 - experiences learned from rural reforms and the SEZs;
 - the nature of a decentralized economy and regionalism
- So far, China turned out to be far better off than most former socialist countries that adopted "big bang" reform approach

Evolution of Institutions



L1: social theory
 L2: economics of property rights/positive political theory
 L3: transaction cost economics
 L4: neoclassical economics/agency theory

Figure 1. Economics of Institutions

Why “big bang” approach is flawed

- Economic transitions from central-planned socialist economy to a more market-oriented economy involves many layers of institutional changes at the same time
- Many institutions (mostly L1 and L2 level in the previous graph) cannot be transformed overnight. These include:
 - legal system
 - political system
 - customs, ideologies, etc.
- Gradualist approach gives a buffer time for these institutions to develop; while big bang approach could only achieve transitions *on paper* (see the funny video that follows)

Why traffic lights not working in Russia

There is law, but nobody cares...

The most dangerous traffic light in th world (Russia)



Link: <http://www.youtube.com/watch?v=H2JFL1Sk21Y>

Growing under Imperfect Institutions

- One the one hand, Chinese economy has been growing fast for over three decades
- On the other hand, China is (or has)
 - non-democratic;
 - heavy-handed government – grabbing hand
 - underdeveloped financial system;
 - no clearly defined property rights
- Some people draw easy conclusions that China's growth was due to:
 - non-democratic regime;
 - interventional government;
 - underdeveloped financial system;
 - unclearly defined property rights
- What's wrong with this logic?

Growing under Imperfect Institutions

- Correlation is different from causation
- China's growth experience illustrates that for an economy to grow, perfect institutions are **ideal, but not necessary**
- China started from a system with huge incentive distortions and a state of backwardness, so any **marginal** improvement could easily start the growth engine
- China's institutions, such as market, political system, legal system, are nowhere near being perfect. However, imperfect institutions (or the second-best institutions) do not prohibit growth and prosperity
- As long as these institutions are constantly improving, the growth can be sustained
- Again, one should really look at things from the evolutionary perspective

How Vietnamese navigate the street

There are no traffic lights, yet people can still move around – how this is linked to our discussion on imperfect institutions and growth

Hanoi Street Crossing



Link: <http://www.youtube.com/watch?v=eC4BN9kInXg>

What can we learn from Chinese experience?

- So far, we have yet to discuss why Bob Fogel (the forecasting guy) holds such optimistic view toward China, yet why he's relatively pessimistic toward Europe
- Now let's discuss the rationale behind his forecast

Fogel's Prediction, again

The Global Distribution of Gross Domestic Product (GDP) in 2040, by Grouping of Nations

Grouping	Population (in millions)	Percent of total	GDP in billions of \$ (PPP)	Percent of total
United States	392	5	41,944	14
European Union (EU 15)	376	4	15,040	5
India	1,522	17	36,528	12
China	1,455	17	123,675	40
Japan	108	1	5,292	2
6 South East Asian Countries (SE6)	516	6	35,604	12
Subtotals	4,369	50	258,083	85
Rest of the World	4,332	50	49,774	16
World	8,701	100	307,857	101*

Note: GDP in U.S. dollars of 2000.

*Total equals more than 100 percent due to rounding.

What caused Europeans to work much less?

Output, Labor Supply, and Productivity

In Selected Countries in 1993–96 and 1970–74

Period	Country	Relative to United States (U.S. = 100)		
		Output per Person*	Hours Worked per Person*	Output per Hour Worked
1993–96	Germany	74	75	99
	France	74	68	110
	Italy	57	64	90
	Canada	79	88	89
	United Kingdom	67	88	76
	Japan	78	104	74
	United States	100	100	100
1970–74	Germany	75	105	72
	France	77	105	74
	Italy	53	82	65
	Canada	86	94	91
	United Kingdom	68	110	62
	Japan	62	127	49
	United States	100	100	100

Source: Ed. Prescott (2004)

What to take away:

1. Most western European countries caught up with US in productivity by mid 1990s, yet GDP per capita was only around 75% of the US'.
2. The output (or income) gap came mainly from the difference in working hours.

Do Europeans prefer more leisure?

- Some argue that the difference in working hours simply reflects Europeans' preference to enjoy more leisure time than their American or Japanese counterparts
- But we need to dig deeper to find out whether this is a matter of **preference**, or something else
- Ed. Prescott, Nobel prize winner of economics in 2004, set out to investigate this matter by looking at differences in marginal income taxes and consumption across countries
- His research shows virtually all the large differences between the U.S. labor supply and those of Germany and France are due to differences in marginal tax rates

What caused Europeans to work much less?

Actual and Predicted Labor Supply

In Selected Countries in 1993–96 and 1970–74

Period	Country	Labor Supply*		Differences (Predicted Less Actual)	Prediction Factors	
		Actual	Predicted		Tax Rate τ	Consumption/ Output (c/y)
1993–96	Germany	19.3	19.5	.2	.59	.74
	France	17.5	19.5	2.0	.59	.74
	Italy	16.5	18.8	2.3	.64	.69
	Canada	22.9	21.3	-1.6	.52	.77
	United Kingdom	22.8	22.8	0	.44	.83
	Japan	27.0	29.0	2.0	.37	.68
	United States	25.9	24.6	-1.3	.40	.81
1970–74	Germany	24.6	24.6	0	.52	.66
	France	24.4	25.4	1.0	.49	.66
	Italy	19.2	28.3	9.1	.41	.66
	Canada	22.2	25.6	3.4	.44	.72
	United Kingdom	25.9	24.0	-1.9	.45	.77
	Japan	29.8	35.8	6.0	.25	.60
	United States	23.5	26.4	2.9	.40	.74

Source: Ed. Prescott (2004)

What have China and Europe in common?

- In Chinese case, it's the reforms that **realigned the distorted incentives**, so people are motivated to work harder, to excel, and get rightly rewarded
- In European case, it's the high tax and welfare system that **discouraged people from hard working** – NOT a matter of preference
- Institutions (tax and welfare system) shaped people's incentives – Europeans **respond to high marginal tax rates by choosing to work less, intentionally**
- To revitalize European growth, similar to China's situation 30 years ago, Europeans need to undertake structural reforms to rectify distorted incentives