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Out of the Darkness

Chinese Transition Paths

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China's rapid economic growth since 1978 has occurred precisely because it has not followed the strategy of parallel partial progression and financial liberalization advocated by Fan and Woo. However, China missed an historic opportunity to build welfare capitalism in the 1980s and 1990s, choosing instead to dismantle its rural health care and educational systems and—as Philip Huang rightly argues—failing to secure workers' right in the burgeoning informal sector. In these respects, China's transition path has been far inferior to that of Britain in the late 1940s and early 1950s. Nevertheless, the global financial crisis of 2008-2009 has discredited Anglo-Saxon capitalism and presents a renewed opportunity for China to build a form of *xiaokang* socialism modeled on the Rheinish capitalism that was so successful in countries such as France, Germany, and Japan before 1989.

Keywords: *China; growth; transition; Rheinish capitalism; Anglo-Saxon capitalism*

The Chinese economy has grown exceptionally quickly since the late 1970s. To be sure, the outlook is cloudier than it was during the globalization "high tide" of the summer of 2008, but 30 years into the transition the Chinese economy remains strong. Global recession has clipped a few points off the growth rate, but the rate remains high by world standards. Indeed, when gross domestic product (GDP) is measured at purchasing power parity (which gives a higher weight to the nontraded sector and hence reduces the statistical impact of the external shock), the slowdown is even less marked.

China's success, argue Fan and Woo, owes much to what they call "parallel partial progression." China was so successful because it did not follow a sequencing approach but instead started reform in almost every sector early on.[1] It was impossible to complete transition quickly in any area, but the process was started almost everywhere and pushed rapidly. A process of sectoral sequencing, whereby reform is started in some areas (but not others) and pushed to a conclusion, would have been less effective.

Nevertheless, China's reform was too slow in some spheres; Fan and Woo single out the slow pace of financial liberalization. As a result, China is unable to exploit the opportunities offered by the availability of foreign capital. Wang Shaoguang shares the optimistic assessment of Fan and Woo. He is critical of aspects of rural health care reform but nevertheless concludes that the Chinese state has shown itself to be both extraordinarily adaptable and good at learning.

Philip Huang is more critical of China's transition path. Much of his article calls for "social justice for the informal sector" in China, namely the creation of institutions and structures to improve the treatment of the 250 million plus informal sector employees inside the factory (in terms of wages and conditions of employment) and outside it (in terms of access to health and education for the children of informal sector workers). But there is no simple neoclassical remedy, argues Huang. Rather, China needs to reject both the market fundamentalism of the last three decades and the state socialism of the Maoist era. And not just for the informal sector: more generally, China needs to pioneer a third way between the polar extremes of left and right.

All these authors thus address in one form or another the two fundamental questions about China's transition path: has it been successful, and what path should China now follow?

The Limitations of Partial Reform

Although I find myself in rare agreement with Fan and Woo on China's failure to move toward democracy (space precludes a discussion of the issues here), the case made for simultaneous reform across all sectors is unconvincing. My reading of the evidence is that China has done well in areas where reform has been both necessary and thorough going (such as agriculture and rural industrialization) and less well in those spheres where reform was either unnecessary or partial. There are many examples of failed partial reform. China's dual track pricing system has been seen by some as an example of a Pareto-improving "reform without losers" (Lau, Qian, and Roland, 2000). But this ignores the opportunities for price arbitrage that the dual track system created. It may have increased output, but it created a rentier class that became wealthy by buying goods in the state sector at low prices and selling on the market at much higher prices. Much of the inequality, especially of wealth, which exists in China today has its origins in the dual track pricing system.

The open door also illustrates the dangers of the partial reform advocated by Fan and Woo. China followed their prescription closely; many years elapsed between the creation of the original four special economic zones (SEZs) at the end of the 1970s and entry into the World Trade Organization (WTO) in 2001. There was logic behind partial opening up; by restricting the scope of *kaifang* to relatively underindustrialized Guangdong and Fujian, China's industrial heartlands (Shanghai and Liaoning) were protected from "capitalist contagion." However, there were real costs. Shanghai's redevelopment was delayed and Deng himself later admitted to have erred in not giving early SEZ status to the great metropolis. More important, the uneven playing field created by partial opening exacerbated regional inequalities, currently one of China's biggest problems.

A third illustration of the dangers inherent in partial reform is offered by China's informal sector. In many respects, the evolution of China's informal sector, as documented by Philip Huang, followed the course laid out by Fan and Woo. Reform was partial: restrictions on the movement of labor from rural to urban China have been relaxed only slowly and little attention has been given to labor conditions. The result has been rapid growth, but the workforce has paid a high price. Huang rightly takes issue with this outcome. There is nothing inherently implausible in arguing along these lines, and the sooner China improves the conditions faced by its informal sector workers, the better. Moreover, raising wages will almost certainly improve efficiency. By reducing the competitive, price-based, threat posed by small-scale enterprises to China's large corporations, it will enable the latter to focus more closely on developing the products and after-sales service necessary to break into global export markets where quality, not price, determines success. Any increase in labor costs in the informal sector will also increase efficiency because it will force small-scale companies to become more capital intensive and innovative.

So the real lesson, contra Fan and Woo, is this: if reform (liberalization, privatization, and democratization) is worth doing, it should be done quickly and comprehensively.

Rheinish Versus Anglo-Saxon Capitalism

The more fundamental problem with the analysis of China's transition offered by Fan and Woo is that they focus on the question of transition paths instead of the ultimate goal. It is not sequencing or coherence that really matters ("the road traveled"), but identification of the optimal endpoint of any transition process.

Fan and Woo implicitly argue that China should aim to replicate the institutions and structures of Anglo-Saxon capitalism—an unregulated financial sector, free trade, a minimal welfare state, and a nonselective industrial policy centered on the development of skills and infrastructure rather than industry-specific subsidies. This is the hallmark of the economies of the United States, the United Kingdom, and New Zealand, and this raft of policies has been increasingly adopted in Western Europe, Japan, and South Korea since 1990. There is, however, an obvious alternative—the Rheinish capitalism pursued in Japan (before the late 1980s), South Korea (before it joined the Organization for Economic Cooperation and Development [OECD]), and both France and Germany prior to the creation of the Euro zone. Selective industrial policy and state control over the banking sector were the core features of Rheinish capitalism, though most Rheinish economies also emphasized the desirability of high wages and (less so in Japan and South Korea) a well-developed welfare state.

The Tyranny of Finance

Fan and Woo are convinced of the superiority of the Anglo-Saxon model. However, the evidence is less compelling. Take finance. Here Fan and Woo are quite explicit in their view of what China should do. They boldly assert that "The biggest bottleneck in the economic realm is the very slow development of private financial institutions. . . . The whole financial system remains dominated by the state sector, and market competition is basically absent." But they, like most neoclassicals, still fail to understand that the global financial crisis of 2009 reflects fundamental systemic flaws. Financial market failure is inevitable; the only way to avoid it is by closing down the market and introducing state control over the banking sector. To be sure, this will hamper the pace of financial innovation, but as it is "innovation" that caused the crisis in the first place, it is hard to see that this is a great loss. China is thus fortunate that it has not yet gone down the American road.

Moreover, the periodic bubbles generated by the financial sector in Anglo-Saxon economies (such as Britain and the United States) are only one example of the failures inherent in financial liberalization. The more serious problem is the inadequate supply of finance for risky long run investment projects and infant industries. Britain provides one obvious example of this financial bias.[2] In part, the British problem is political (Ingham, 1984). Finance ("the City") exerts tremendous influence over British governments; one sign is the way in which bankers under investigation for speculation and sheer incompetence have nevertheless been appointed to Britain's Financial Services Authority (the central regulatory body) and as government advisors. More generally, macroeconomic policy has exhibited a persistent deflationary bias. Even at the height of Britain's long end-of-century boom, unemployment remained high because the City (as represented by the Bank of England's Monetary Policy Committee) feared inflation more than it feared unemployment. China runs exactly the same risk in implementing financial liberalization; the resulting spiral of inequality will strengthen financial capital and in so doing weaken the Chinese state.

The other reason for inadequate industrial investment in the Anglo-Saxon economies is the short termism that characterizes banking lending, resulting in few long run loans and insistent demands for a quick payback. As a result, the British economy has become dependent on financial services, with all that means in terms of vulnerability to shocks and a slower long run pace of technical progress. Britain's problems in this regard have been known for years (they were mentioned in the 1931 report of the Macmillan Committee), but nothing has been done because of the political power of finance capital. In contrast, Germany and other Rheinish economies set up state-owned development banks (such as K.f.W), which played a key role in extending long run finance to small- and medium-sized companies, Germany's famous Mittelstand.

The financial liberalization proposed by Fan and Woo will therefore cause more problems than it will solve—just as it did in South Korea, where the crisis of 1997-1998 was caused not by regulatory failure but by the abandonment of industrial policy (Chang, 1993). Capital market failure is pervasive in Anglo-Saxon economies and can only be avoided by state intervention. This is one area in which the Chinese economy needs a little more socialism—getting rid of its casino-like stock markets would be a start—and a lot less reform.

Welfare Capitalism and Dynamic Efficiency

Yet the case against Anglo-Saxon capitalism goes well beyond financial market failure. It is one of the more extraordinary facts about the U.S. economy that the median hourly real wage has barely changed since 1973 despite rapid productivity growth. Moreover, the dispersion of wages and the extent of relative poverty are greater than in any other affluent country (Nickell, 2008). The long hours worked in the United States should be contrasted with the situation in France, where the population has chosen to trade-off slower GDP growth in favor of increased leisure. Some neoclassicals (like Olivier Blanchard) have tried to demonstrate that the French "mistakenly" choose leisure because their economy is overtaxed and overregulated, but this is ideological desperation: it is the preference for leisure that determines the tax and regulatory system, rather than vice versa. It is also worth reminding ourselves that the U.S. insurance-based system of health care, so admired by Chinese policy makers in the 1980s, costs around 90% more than the rich country average. Yet life expectancy is no better than the average and around 50 million Americans are without insurance.

Although there is thus a clear *prima facie* case for Rheinish capitalism on welfare grounds, the case in terms of dynamic efficiency seems less clear cut. Piore and Sabel (1984) famously extolled the merits of small-scale craft-based industries, and these are a feature of Japanese capitalism. However, the performance of Japan's informal sector gives pause to anyone arguing for small-scale industrial and service enterprises. The most advanced subsectors of Japanese manufacturing (cars, for example) bear comparison with anything in the world, but the "traditional" component of this dual economy is remarkably unproductive. This is true of small-scale agriculture. It is even more true of the service sector. One example makes the point. In 1999, the average Japanese supermarket had a floor area of only 832 square meters compared with around 4,200 square meters in the United States (OECD, 2008: 131, 145).

More generally, productivity growth in Japan, Germany, and France has been slower than in the United States and the United Kingdom since 1995 (Table 1). This contrast in performance is especially marked in the service sector, apparently because of the slow take-up of information and communications technology (ICT) in the retail and wholesale distribution sectors. In Japan's case, labor productivity growth in services fell from 3.5% per year during 1976-1989 to only 0.9% in 1999-2004. Moreover, the growth of service sector productivity in Japan was only about a quarter of that in manufacturing between 1999 and 2004; the gap was much smaller in the United Kingdom and the United States (OECD, 2008: 126).

There are, however, several problems with this seemingly damning indictment of Rheinish capitalism. First, the economies of Japan, Germany, and France have largely *abandoned* Rheinish capitalism over the last two decades, and poor recent performance reflects this. In Japan's case, for example, the "lost decade" partly reflects the aftermath of the property bubble of the late 1980s, which itself only occurred because Japan acceded to U.S. pressure to reduce interest rates to prop up the dollar. More important, it reflects the growing influence of the Washington consensus in

Table 1
Growth of Labor Productivity, 1959-2008 (GDP Per Hour Worked; Percent Per Year)

	1959-1973	1973-1989	1989-1995	1995-2008
Germany	5.3	2.7	1.9	1.5
France	4.9	3.0	1.9	1.6
Japan	8.6	2.8	2.6	1.9
United Kingdom	3.6	2.7	3.0	2.2
United States	2.6	1.3	1.3	2.1

Source. University of Groningen database at http://www.conference-board.org/economics/database.cfm.
Note. Germany pre-1989 refers to West Germany.

Japanese policy circles, as indicated by the abolition of MITI (Ministry of International Trade and Industry) and the enhanced power of the (conservative) central bank (Werner, 2003), such that Rheinish capitalism was effectively abandoned in the early 1990s. When Rheinish industrial policy was properly implemented (the postwar period before 1989), labor productivity growth in the Rheinish economies was comfortably above that achieved in Britain and the United States. Some of this was due to catch-up but not much; France and (West) Germany had caught up with Britain in terms of GDP per hour worked by the early 1960s, and the United States by around 1990.

Second, even if it is accepted that the economies of Japan, Germany, and France were "Rheinish" after 1989, their poor performance over the last two decades is more because of macroeconomic mismanagement (slow growth of demand, to be precise) than supply side failure. This deflationary bias matters because, as Nicholas Kaldor recognized many years ago, productivity growth depends first and foremost on the rate of growth of demand. In the cases of Germany and France, the underlying problem has been the conservative macroeconomic policy pursued within the Euro zone by the European Central Bank. Germany's problems have been exacerbated by the need to absorb East Germany. In Japan's case, the growing power of the central bank ensured that the demand side response to the problems of the mid-1990s was weak and half-hearted. Of course, Japan has supply side problems, but the fundamental problem is on the demand side (Krugman, 1999).

The impressive record of the Rheinish economies during their pre-1989 "golden age" thus provides strong evidence to support the adoption of this model in China on both welfare and efficiency grounds. That case is stronger still if one believes, as I suggest above, that the political influence of the financial sector in the Anglo-Saxon economies threatens the long-run sustainability of economic growth.

Building Xiaokang Socialism: The Road Not Taken

In some respects, the development path taken by China before the middle of the 1990s suggests an acceptance of the desirability of Rheinish capitalism. In the years before Deng's death, China adhered closely to the Rheinish model by pursuing an active and effective industrial policy, especially in rural areas where the growth of township and village enterprises (TVEs) was driven by local government. China's strategic (i.e., partial) integration into the world economy limited competition from imports and allowed the state to begin the construction of a globally competitive industrial sector. This Rheinish model was abandoned in the decade after 1996. The decision to privatize state-owned industry in both city and countryside, and China's entry into the WTO, both suggest a conversion to Anglo-Saxon capitalism. So too the acceptance of stagnant real wages for unskilled workers in Guangdong over the last decade, evoking comparisons with the trajectory of median wages in the United States.

Yet even before 1996, the Chinese state—whilst following the Rheinish prescription for growth promotion—ignored the welfare dimension of Rheinish capitalism in the key areas of education and health care. In this respect, the years of Dengist rule were a missed opportunity. In the late 1970s, China's policy makers had it within their grasp to create a uniquely Chinese form of welfare capitalism—xiaokang ("modest prosperity") socialism, for want of a better phrase. Mao had bequeathed to the Chinese nation an embryonic welfare state. Some 90% of children were already enrolled in junior middle school in 1976-1977 and, as Wang Shaoguang shows, more than 90% of villages had established a cooperative medical system (CMS). Would it have been so very difficult to have expanded secondary education, to have raised the quality of rural health care, to have improved the training of the famous barefoot doctors, and to have provided medical services to those employed in the informal sector?

Instead, China's transition path left no room for the development of xiaokang socialism. There was no thought of expanding senior middle school enrolment. Even junior middle school education was deemed an unnecessary luxury for the Chinese peasantry and enrolments were slashed.

By the nadir of the mid-1980s, the progression rate from primary to junior middle school had fallen below 70% (SSB, 2005: 81-82). The same story of decline is told by the data on rural health care. The demise of the commune led inexorably to the collapse of CMS; by 1983, it operated in only 11% of Chinese villages. Wang argues that we should recognize that China's autocratic state is remarkably good at learning and highly adaptable. Yet the empirical part of his paper on rural health care suggests the opposite. The China of the late 1970s had a low-cost and relatively efficient system of health care that was close to providing universal coverage in the countryside. Instead of improving its quality and extending its coverage, the system was dismantled. In its stead emerged a system of payment at point of delivery, the sort of system which had operated patchily before 1949 and which guaranteed that the bulk of China's rural population was left without access to health care. This is an example neither of learning nor of pragmatism. For all the much vaunted "black cat white cat" rhetoric of Deng's regime, it demonstrates that the 1980s were a decade when ideology was in full command.

To be sure, China was a poor country at the close of the 1970s. According to Maddison's (2003: 59, 147, 184) estimates, per capita GDP in China in 1978 was only half that of Cuba and on a par with that of England in 1700. This consideration undoubtedly narrowed the horizons of Chinese policy makers. Nevertheless, it appears odd in retrospect that the Party was so eager to jettison the welfare dimension of Maoism. There was no political imperative to do so; the expansion of health care and education in the late Maoist era was remarkably popular. More significantly, the very fact that China had created this sort of welfare state even in the early 1970s suggests that it could have been continued into the 1980s. Indeed, the growth dividend generated by the breakneck expansion of agricultural output and rural industry would have made it easier to sustain and expand China's embryonic welfare state.

Moreover, although the Chinese transition is often (favorably) compared with transition in Russia, the better (but less favorable) comparison is surely with postwar Britain. The British economy on VJ day was in a parlous state (Clarke, 1996). It was in many ways a typical planned economy: defense spending was very high, consumer goods were rationed (bread was actually added to the list in July 1946 to ensure that adequate cereals were available for the German population), its housing stock had been decimated by bombing, and the country faced the problem of demobilizing the five million men and women who were in uniform. No wonder that Correlli Barnett (1995: 174) compared Britain in the late 1940s with Russia in the early 1990s.

Britain's other problem was that it was a small open economy and therefore dependent on exports and a capital account surplus to meet its consumption needs. But its export industries were in ruins and its overseas assets had been sold off. Britain therefore faced the immense challenge of becoming once more a workshop economy capable of meeting its import requirements by the export of manufactures (Rowthorn and Wells, 1987). Yet despite all these problems, the British government committed itself to building a "New Jerusalem" based around universal health care, continued state ownership of the key utilities, and a system of national insurance to finance pensions and other welfare payments; in addition, a massive program of house building was launched. Of course, wartime damage notwithstanding, Britain was not poor in 1945; and it would have been easier to finance the New Jerusalem had Britain abandoned its continuing imperial delusions. Nevertheless, one is struck by the grandeur of Britain's postwar vision and by the remarkable fact that so much of it was realized and has endured.

In contrast, China's problems at the close of the Maoist era were slight. Jobs had to be found for those returning from the countryside, but the challenge was modest when compared with Britain's in 1945. Contrary to the views expressed in the literature, the Chinese economy was not on the verge of collapse; the agricultural crisis was weather-induced and industrial output was depressed only temporarily by the political disruptions of 1976. In fact, China's long-run growth path was shifting upwards in the 1970s as a result of the application of green revolution technology in agriculture, the growing maturity of its rural industries, and producer good imports. Moreover, China in the 1980s enjoyed the priceless advantage of being large. It could therefore engage with the world economy in a strategic way, pursuing a policy of selective protection for its infant industries and only gradually expanding its export sector. Britain enjoyed no such luxury.

Yet despite all these advantages, the horizons of Chinese policy makers were strictly circumscribed in the late 1970s. There was little thought of building xiaokang socialism but instead an almost idolatrous devotion to growth. In retrospect, their poverty of ambition is stark. China thus missed an historic opportunity to build a genuine alternative to Anglo-Saxon capitalism. Still, that option remains open because the American model, and those Chinese economists who argue for its wholesale adoption, are so discredited by the global crisis of 2009. There have been recent signs that Wen Jiabao and Hu Jintao recognize the alternative modernity open to them. The opportunity to move decisively toward xiaokang socialism is now ripe.

Notes

1. By "reform" they mean the creation of a neoliberal polity: market-orientated economic structures combined with liberal democracy.

2. For a useful introduction to the extensive literature, see Lee (1996).

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