

China

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Abstract

There has been much discussion of the “China Model” and to what extent it can be replicated. China’s success can be explained through three relationships: domestic and international, economic and governmental, and central and local. Implementing domestic reforms and opening up internationally created a virtuous cycle where adapting to international standards facilitated foreign direct investment and the exchange of ideas which then enabled further domestic reform. Meanwhile, a delicate balance was maintained between economic reform and governance reform, with particular attention paid to the pace of each process so that internal stability could be maintained. Likewise, there was also careful management of the evolving relationship between the central government and local governments, which was alternately characterized by decentralization and centralization. Adaptive learning during the policy making process has been critical throughout. Future challenges include: unfinished economic reforms, relations between the central government and civil society, environmental sustainability, and emerging global expectations.

Keywords: central planning, economic reform, decentralization, governance reform, state-owned enterprises, adaptive learning, stability

Introduction

It has been more than thirty years since China adopted a policy of “reform and opening” in 1978, which led to rapid economic growth and social development that lifted millions of people out of poverty. Chinese society has also changed from a relatively rural and closed, to a rapidly urbanizing and open society. In addition, China’s governance system transitioned from one that is primarily based on individual will and charisma, to one that is increasingly institutionalized and strives to achieve efficiency and professionalism. Debates have raged as to what accounts for China’s success and what lessons can be drawn, on whether a “Beijing consensus” offers an alternative to the “Washington consensus.” This chapter looks beyond ideological debate and provides a richer account of the development process that reflects upon the mistakes and pitfalls of China’s experience. It focuses on the role of government both as managing the evolution of an economic system, and as adaptive learning in the arena of public policy. The chapter ends by identifying challenges and prospects for China’s future development.

An overview of development

The rapid change in every aspect of China's economy and society makes it hard to see a clear pattern of change. This section provides a before and after look at China's economy and government in order to provide a benchmark for later discussion.

The legacy of central planning

The Chinese success story comes after 1978, when China abandoned the planned economy system. But the legacy of the central planning period is complicated. On one hand, it saw China rapidly create a basic framework and foundation for education, science, technology, and industry. Public health services were extended to the bulk of the population, and the quantity and quality of China's human capital was greatly improved. On the other hand, the planned economy—and the system of centralized authority that it embodied—deprived the grassroots of initiative, and occasionally led the country in disastrous directions. In this sense, the planned economy laid the basis for later success in market reforms, while also creating the need for comprehensive reform.

After its founding in 1949, the People's Republic of China adopted a central planning economic system in an effort to emulate the Soviet Union. A large share of the country's economic output was directed and controlled by the state, which set production goals, controlled prices, and allocated resources throughout most of the economy. During the 1950s, all of China's individual household farms were collectivized into large communes, and industrial and commercial enterprises were transformed into public enterprises. It was taken for granted that a socialist country would make public ownership the foundation of its economic system, and private enterprises and foreign invested firms were nearly non-existent.

To support the country's rapid industrialization, the central government invested heavily in physical and human capital from the 1950s to 1970s. A public healthcare system, covering most of the population—urban and rural— was established for the first time, with a tremendous impact on public health. From 1950 to 1982, life expectancy rose from forty-two years to sixty-six years, while the child mortality plummeted by 75 percent, from 146 per thousand live births to 36 per thousand live births (Wang and Mason 2008), leading to a doubling of the population (from 552 million to just over one billion). The quality of

human resources also increased, as the illiterate rate dropped substantially from 34 percent in 1964 to only 4 percent in 2010. Meanwhile a highly centralized science and technology system was established, starting in the 1950s, with scientists, researchers, and engineers organized to serve various national goals, laying the cornerstone of China's military and industrial development.

By 1978, centrally-controlled, state-owned enterprises (SOEs) produced nearly three quarters of industrial production. Since the government aimed to make China's economy relatively self-sufficient, foreign trade was generally restricted to those goods that could not be produced domestically. Government policies kept the economy relatively stagnant and inefficient due to a lack of profit incentives for firms and farmers, the absence of competition, and the widespread distortions which caused by unrealistic price and production goals. China's living standard was substantially lower than those of many other developing countries at the time.

From 1966 to 1976, the Cultural Revolution swept the country,¹ as millions of people were persecuted in the violent conflicts and suffered a wide range of abuses. The country's political system was paralyzed and the economy was pushed to the brink of total collapse. Most people suffered tremendously from the constant political movements and yearned for stability and a better material life. The emerging leadership after the Cultural Revolution, led by Deng Xiaoping, was a group of vanguards that had experienced the era of central planning system and the disaster of the "Great Leap Forward."² They recognized the limits of the planned economy—after thirty years of unsuccessful experiments and ten years of chaos—and as a result were much more practical than their predecessors.

Major outcomes since 1978

China underwent fundamental economic transformation over the past thirty years, among the more salient features of this reform era are: rapid growth, structural change, privatization, and improved living standards.

Rapid growth. The gross domestic production (GDP) in 2010 was twenty times of that of 1978, and the official annual GDP growth rate during 1978–2010 was around ten percent. By 2011, China's overall GDP was second only to the United States, yet the per capita GDP exceeded US\$ 4,700 was still feel short of the US \$7,500 average for upper-middle-income countries.

Industrial structure change. China experienced rapid structural change, most prominently in the transformation of employment. While seventy percent of China's workforce was engaged in agriculture in 1978, this figure had fallen to thirty-seven percent by 2010. The shift from low-productivity agriculture to more productive industries and services provided a crucial driving force for rapid economic growth. At the same time, high investment stimulated rapid growth of the capital stock, which in turn created a large number of employment opportunities in non-agricultural sectors. Investment in national infrastructure included a network of expressways, electrified railroads, electricity grid and a modern electronic communications infrastructure. By 2010, China had a total of 32,700 kilometers of electrified railway and 74,000 kilometers of expressway, connecting the country and allowing people to ride between Shanghai and Beijing in less than five hours by high-speed rail.

Increased privatization. The ownership structure of the economy also changed dramatically with government's effort to develop the private sector. In 1978, public ownership took up ninety-nine percent of the GDP, which decreased to thirty percent in 2008. While the private sector has become the main force to boost China's economy, the state-owned sector remains dominant in some of the most important industries, including infrastructure, energy, and telecommunication. After 1978, China's economy accelerated its integration into the global economy, with foreign direct investment's share of GDP peaking at 5.7 percent in 1994 and international trade share of GDP peaked at seventy percent in 2006. As a result, China became the "world's factory" manufacturing a wide range of goods.

Improved living standards. Despite a strict family planning policy since 1980, the total population exceeded 1.3 billion by the end of 2010, up forty percent from 1978. Nonetheless the rate of population growth decreased from twelve percent in 1978 to less than five percent in 2010. Citizens' living standards rose rapidly, with a substantial rise in incomes for both urban and rural areas. According to the domestic poverty standard, the number of people living below the poverty line in rural areas fell to several million in 2010, compared to approximately 250 million in 1978.

Domestic reform and global integration

The enormous changes that transformed China since the beginning of the reform era have their origin in the evolution of the economic system. The transition from a planned to a market economy was not the outcome of a blueprint, or a pre-determined step-by-step process, but an evolutionary process driven by the interaction between government and enterprise, and between institutional incentives and individual behavior. This type of incremental reform has been labeled as “crossing the river by groping for stepping stones.” This section, analyzes three stages of the post-1978 development process, and provides an account of the political and social rationales behind it.

Decentralization and opening up (1978-93)

Beginning in late 1978, China launched a series of major economic reforms which started in the agriculture sector. The central government allowed farmers to sell a portion of their crops on the free market after fulfilling state grain quota obligations, and local governments began to sign long-term leasing contracts of farmland with local farmers. Therefore, vast numbers of agricultural workers became available for non-agricultural employment,

especially in township and village enterprises (TVEs) which grew rapidly to meet pent up demand for consumer goods. Reform in this period can be characterized as an evolutionary process of administrative and fiscal decentralization to local governments and enterprises. Local officials gained greater autonomy over the local economy, including the power to set prices, to invest with self-raised funds, and to restructure their firms and issue licenses to newly established firms. More importantly, authority over state-owned enterprises devolved to local governments at the provincial, municipality, and county levels. By 1985, the state-owned industrial enterprises controlled by the central government accounted for only twenty percent of the total industrial output at or above the township level, while provincial and municipality governments controlled forty-five percent and county governments thirty-five percent (Qian and Xu 1993).

This administrative decentralization was also accompanied by a fiscal contracting system between central and local governments. Although fiscal contracting schemes varied both across regions and time, the main idea was that provincial governments contracted with the central government on the amount of fiscal revenue to be remitted for the next year(s), while they could keep the rest. This system was maintained until the end of 1993 (Montinola et al.

1995). Fiscal decentralization provided powerful incentives for local authorities to seek revenue in order to pay for their expenditure responsibilities (Oi 1992; Walder 1995; Wong 1992). With decentralization, local governments now had an incentive to develop local economies and to step up their efforts in revenue collection. At the same time, local government also started many local state-owned enterprises, as well as TVEs. Therefore, as economic control of various enterprises was given to provincial and local governments, these firms were generally allowed to operate and compete in the market rather than under the direction and guidance of state planning.

Opening to the outside world began in the earliest stage of economic reform. New forms of trade started in Guangdong province and gradually spread nationwide. The huge gap in technology and living standards gave local governments a strong incentive to import production lines and initiate cooperation and joint ventures with foreign companies. In this way, new and used production lines for automobiles, integrated circuits, and color televisions were imported. Because many of these products were not previously available in China, there was relatively little business risk in making industrial investments, yet—as competition between regions intensified and regions followed similar development strategies—investment

became excessive and led to surplus capacity. Under these conditions, local protectionism reared its head, national market integration was obstructed, and bad investments led to an increase in non-performing loans in the banking system (Naughton 2007; Yang 2004). It became essential to make fundamental choices about the strategy of China's market reform.

In addition, during the 1980s, Special Economic Zones and Coastal Open Cities³ became an important symbol of reform in which governments adopted preferential tax, land, and trading policies for foreign firms and joint ventures. By watching and participating in this activity, Chinese enterprises learned modern market practices and gained management experience, especially on entering the international market. With the local economy dominated by local government-owned enterprises, regional competition for the foreign direct investment (FDI) was not yet a big story during the 1980s and early 1990s, since FDI was highly concentrated in few pilot cities and competition for such investment from other regions was minor.

Market institutions and integration (1994–2001)

By the mid-1990s, reforms based on decentralization lost impetus, creating momentum for reforms based on a more complete system of markets and property rights. What followed was an astonishing period of radical and comprehensive institutional reforms between 1994 and 2001. Wu Jinglian (2010) sees this as the beginning of the comprehensive reform that created the basis for a market economy, while Naughton (2007) argues that the 1990s reforms represented a move in the direction of a competitive market economy with a “level playing field.” As China became a more competitive society, there were also social costs to bear, not the least of which was a widening gap between the winners and losers of market competition. For example, Huang Yasheng (2010) sees 1993 as the beginning of policies that favored government and corporate interests at the expense of ordinary citizens.

From the mid-1990s, China carried out a series of reforms for a *normal* market economy, such as price reform, tax and budgetary reform, foreign trade, banking, SOEs, and entry into the World Trade Organization (WTO). As a result, FDI increased, inter-regional trade barriers declined, and a much more integrated domestic and global market emerged.

The transition toward a market economy was also forcing government policy-makers to adapt. Two parallel tax collection systems were built up during the tax reform in 1994, which dramatically enhanced the fiscal centralization of the central government, so to disrupt the decentralized incentive bases of the locals. Many local governments began to divest from SOEs they owned. A large-scale restructuring of these public enterprises was inevitable (Li, Li and Zhang 2000). By the end of 1996, 70 percent of small SOEs were privatized in pioneering provinces and half were restructured in other provinces (Cao, Qian and Weingast 1999). In 1978, nearly four-fifths of the total industrial output in China came from SOEs. By 1997, the SOEs' share had shrunk to slightly more than a quarter. As SOEs and TVEs reform gained pace in the late 1990s, about twenty-five million SOE and collective employees were laid-off from 1998 to 2002 and most local SOEs and TVEs were privatized by the late 1990s (Qian 2002).

As most state-owned firms were privatized, central and local governments could no longer extract resources from bankrupt SOEs and TVEs. The role of government in economic development gradually changed from the shareholder of state-owned or collective enterprises to a tax collector from the market. Local governments became keen on cultivating new

local tax bases by attracting private investment, especially manufacturing investment from overseas. Local officials eagerly courted foreign as well as domestic investors to invest in the thousands of industrial parks that have mushroomed across the country. By the end of 2003, China has more than 3,800 local “development zones” or “industrial parks”, among which only six percent were approved by the central government. This change of attitude and behavior of local governments brought about a new form of local development in the mid-1990s. Land development and competition for investment—both driven by local government—became a major driver of China’s national economic growth. At the same time, it has helped produce an extremely pro-business environment, resulting in over-investment in manufacturing capacities and lax environmental and labor regulations.

This period of reforms culminated with China’s entry into the WTO, committing the country to a new level of openness and a set of globally-accepted norms and practices. At the same time, following a policy of “exchanging market access for technology transfer,” Chinese firms began to accumulate experience and participate in international production networks in sectors such as automobiles, communications equipment, home appliances, and computers. China became the “world’s factory,” and foreign trade increased from 24 percent of GDP in

1994 to 44 percent in 2001. However, China continued to lag behind in product design, development, and technological innovation.

Innovation and harmony (2002–present)

Lately China began to reap the benefits of the 1990s reforms, gaining a surge of rapid growth in GDP. A well-funded central government shifted its attention to economic and social issues, while local development trends were much more difficult to change. After entry into the WTO, to the surprise of many, most industries survived in the expected onslaught of foreign competition. Growth peaked in 2007, when GDP grew by fourteen percent, an economic success that once again changed the relationship between government and the economy. The central government was now well-funded as tax reform ensured that the central government's financial needs were met. The remaining central government enterprises were restructured and rationalized under the State Council's State-owned Assets Supervision and Administration Commission (SASAC). Helped by their monopolistic market positions, large SOEs began to generate healthy profits that further improved the central government's financial position.

At the same time, powerful interest groups were created, including those associated with the newly profitable central state enterprises. In some respects, the successes of reform and opening-up created a new systemic inertia (Xue and Chen 2010). Many new interest groups rely on the early reform-oriented policies and resist any new changes that might hurt their interests; thus slowing the pace of reform. In addition, the dramatic disruption in the social fabric owing to the 1990s reforms also reached an alarming level that called for a new focus on social policy. When Hu Jintao became party leader in 2002, he began to push a broad array of policies designed to improve social security, protect the disadvantaged, improve living conditions in rural areas, and improve the environment. This agenda sought to follow a “scientific approach to development” in order to build a harmonious society.

The most dramatic set of policies were those in rural areas for which the central government assumed budgetary responsibility, with transfers to fund primary education and significant contributions to a new rural health insurance program.⁴ At the same time, the agricultural tax was abolished and grain growers received new support to increase the profitability of farming.

Social policies in the urban areas also saw major change as the State Council established the legal rights of migrants to live and work in cities, and for their children to be educated in urban areas. A new Labor Contract Law came into effect in 2008 to provide new protection for workers, improving workplace safety, with a special focus on coal mines. Great efforts have also been taken to address the problem of the environment, with the 11th Five Year Plan (2006–10) aiming to reduce emissions and energy intensity by 20 percent. There is some evidence that China is reaching a “Lewis turning point” (Cai, Meng and Bai 2008), with the central government attempting to shift to a new economic model propelled by knowledge and innovation rather than cheap labor, resource depletion, and environmental pollution. Such a transition requires not only a more skilled work force, but also a better market environment that fosters innovation. The government set out to build an innovation-based country in 2006, and introduced reforms to science and technology policy in 2011 aimed at putting enterprises at the center of a national innovation system.

Local governments in a difficult position were left out of the robust fiscal increase that the central government enjoyed. Local governments plunged into land development and

infrastructure investment, but also struggled with “unfunded mandates” from the central government. During the global financial crisis (2008-2009), local governments were encouraged to initiate ambitious local spending plans, which often included the issuance of local government debt. In comparison to previous periods when the incentives for central and local governments were compatible, this period saw a different incentives for central versus local government. Central leaders took advantage of the healthy financial situation to address long-deferred social issues and put further economic reforms on the back burner, while local officials turned their attention to local economic growth and gaining resources to run their “pet” projects.

Governance since 1978

Most studies on China’s development over the last thirty years focus on economic reform and rapid growth, neglecting changes in the country’s governance. This is partly due to the fact that, until the early 2000s, many reforms in the public sector were either bundled with economic reform or perceived as for the sake of economic development. While the transformation of China’s governance system is far from complete, the interaction between economic reform and governance reform has characterized development processes over the

past thirty years. The following discussion briefly describes China's governance system and pre-reform conditions, then identifies three aspects of change: political stability, gradual government reform, and adaptive learning.

Governance and pre-reform conditions

At the national level, the central government comprises five major subsystems: the National People's Congress (legislation); the State Council (administration); the Central Military Commission (defense); the Supreme People's Court and the Supreme People's Procuratorate (judicial). CCP retains its control of the entire system through the Politburo of the Central Party Committee and the relevant party organs, and recommends leaders to all other subsystems. This governance system is duplicated at the provincial, municipal, and county levels. This system functioned relative well in the early years after 1949, however, as Mao Zedong became increasingly authoritarian, the system ceased to function normally, leading to the disastrous "Great Leap Forward" and the Cultural Revolution.

Deng Xiaoping felt strongly that major reforms were urgently needed to bring China out of political and economic crisis, yet his leadership faced several challenges. First was to maintain political stability when the Party faced attacks from both Mao loyalists and those calling for a Western-style democracy. Second was the challenge of reconciling economic reform with classical Communist doctrine, and third was ensuring a succession in leadership. Deng and his colleagues were all in their seventies or older when the Cultural Revolution ended, raising questions regarding a future transition of power to a younger generation.

There are many interpretations of how China responded to these challenges. Some credit China's success to one party rule (Yu 2002; Hu, Wang and Zhou 2009) while others point to political patronage networks created at different stages of transition (Naughton 2008). In contrast, this chapter argues that political stability, gradual government reform, and adaptive learning combined in the evolution of China's governance system over the last thirty plus years, and allowed for "taking bold initiatives and then scrambling to adjust to the consequences and keep the effort moving forward" (Lieberthal 2004). In particular, China's gradual approach toward governance reform manifested itself differently when compared with reform in the economic system. With reform of the economic system, the fundamental

structure of the economy changed gradually from a central planning system to a market-based system, yet political reform left the governmental architecture largely intact while changing the subsystems within it.

Maintaining stability

To address the three above-mentioned challenges, Deng Xiaoping wasted no time to rehabilitate thousands of cadres who had been persecuted, shifting society's focus from political movements to economic development. However, debates and tension soon began to rise between those who insisted that China should stick to the Mao Zedong's approach, and those who felt that China needed to reflect on the causes that led to the Cultural Revolution and engage in a fundamental political reform. Such differences existed both inside and outside the Party. A clear direction and strategy was needed. In March 1979, Deng Xiaoping articulated the "four cardinal principles", calling for adherence to the socialist road, to the people's democratic dictatorship, to the leadership of the Communist Party, and to Marxism-Leninism and the thoughts of Mao Zedong. These four principles struck a balance between the two sides and indicated that China was not interested in the kind of open political

debates, such as “Glasnost” that later became a signature of political reform in the former Soviet Union. Deng intended to maintain political stability. These principles reaffirmed the leadership of the Party and helped it to stay focused on economic development during the “primary stage of the socialism” which was expected to last more than fifty years. The principles also set boundaries for debates and decisions about the directions of reform in later years.

To address the second challenge, namely, reconciling the potential contradictions between a reform agenda and the Mao/Communist doctrines, Deng advocated for “seeking truth from facts” which allowed unconventional thought and bold experimentation. A new conceptual framework would be created every several years, including the concept of the *Socialist Market Economy* (1993),⁵ the *Three Represents* (1997),⁶ and the *Scientific Development Perspective* (2003).⁷ While the effectiveness of these frameworks varied, they represented an earnest effort by the Party to keep pace with the progress of society.

The third challenge related to the issue of succession. The failures of Mao Zedong in selecting his successors made Deng Xiaoping keenly aware of this problem, and he began to build a stable and predictable succession, including limits on the power of the core leader,

selection and grooming of two successors, retiring leaders of his generation, and enhancing the importance of institutions and procedures (Liberthal 2004). While such efforts did not ensure smooth transitions for Hu Yaobang and Zhao Ziyang in the 1980s, it paid off for the transition to Hu Jintao in 2002 and to Xi Jinping in 2012. Recently new experiments have improve institutions and procedures, particularly a vote of top leaders in the Politburo of CCP by its Central Committee members starting in 2007, which contributed to the selection of Xi Jinping and Li Keqiang as the core of the new leadership in 2012. Succession at lower levels is largely the responsibility of the Party's organizational departments which are in charge of selecting, fostering, and appointing/recommending party and government officials. This institutional arrangement has allowed the party to maintain a firm control over a country. In the early 1980s, Deng Xiaoping promoted several criteria in the selection of party and government officials, including age, professionalism, education, and loyalty to the party. Under these criteria, a major turnover of political elites in the 1980s and 1990s brought in many younger, better-educated, and more reform-minded officials. More recently, the selection and appointment process has been further institutionalized along with civil servants reform.

Gradual reforms in the government

While China's leadership chosen to maintain political stability, gradual reforms in the government continued. These were driven by the need for government function, organizations, and behavior to fit with the new market-based economic system; pressure from local governments for more authority and resources; and integration into the global system following entry into the WTO. The Chinese government made great effort to restructure agencies, streamline processes and procedures, and improve behavior to fulfill its commitment to WTO. During the five years following 2001, nearly three thousand pieces of legislation were abolished, revised, or created at the central government level, and a further 200,000 pieces of legislation and regulations at the local level (Xue and Zhong 2012).

Changes in the government were carried out through public administration reforms in 1982, 1988, 1993, 1998, 2003, and 2008 respectively, corresponding to terms of the National People's Congress. These reforms sought to improve the effectiveness and efficiency of the government by simplifying organizational structures and streamlining operations. The 1998 reform carried by Zhu Rongji abolished several ministries and reoriented the remaining ones

to focus on macro-management, policy guidance, and coordination. In the end, the State Council shifted 280 functions from the central government agencies to state-owned enterprises, social intermediate organizations, and local governments. It also closed fifteen ministries, created four new ministries, and cut the size of central government workforce by over 47 percent (Zhang 2009).

Adaptive learning in policy making

The policy making process also underwent gradual change, starting in the late 1970s with a loosening of control by the central government, giving greater autonomy to local governments. Subsequently, domestic and international influences led to a recentralization of some decision making authority so that major reform measures could be pushed through. More recently there was a gradual involvement of the general public in the public policy process. The decentralization and recentralization of decision power within government, and the increased participation of the general public in the policy process, has been an adaptive learning process of experimentation, synthesis, and institutionalization.

During the first stage of reform, China's policy-makers followed the experimental approach, adopting policies cautiously and incrementally. For example, Special Economic Zones were created in four coastal cities (including Shenzhen) and then gradually extended nationwide. While Deng Xiaoping and a small group of political elites set up the reform agenda and tried to control the pace of the reform, the result was more freedom and autonomy to local governments for experimentation. External advice was sought from time to time while an internal policy research system was also established (Wu 2010). Many reform proposals, such as the "dual track price system", were often debated among senior officials and scholars.

By the end of the 1980s, the consensus among the CCP leadership was shattered, with the Party feeling a sense of crisis in the wake of the Tiananmen Square incident and the collapse of the Soviet Union. The central government was concerned about eroding revenue and that it had lost much of its control over the economy. These events inspired a recentralization, with Jiang Zemin and Zhu Rongji reconsolidating the power of the central government in an effort to institutionalize the policy making agencies and procedures. Decision making was elaborately organized, and opinions from outsiders were carefully channeled and filtered by the government ministries. Although the final decisions were still made by the top leaders,

consensus and a balance of interests among ministries were essential for policy success.

Procedures were also improved, for example with the introduction of a system of public hearings for the price of public services in the *Administrative Penalties Law* in 1996 (Peng, Xue and Kan 2004).

From 2003, the government's focus gradually shifted from economic growth to social development and technological innovation. Major policy decisions began to go through expert consultation, feasibility review, and public consultation. This process created a competitive policy-idea market (Xue and Zhu 2009) open to decision-makers and outside stakeholders. At the same time, policy-makers became more professionally educated, often with foreign experience, providing further impetus for the institutionalization of the policy making process.

A China Model?

Synthesis

Looking back at China's development experience over the last thirty years, it is difficult not see China's experience as unique and of limited potential for repetition in other developing countries. From a global perspective, China's high rate of economic growth was not a "miracle", but mirrored the rapid economic growth accomplished earlier by Japan, Korea, and Taiwan. Each of these economies grew rapidly through the change from a rural to an urban economy, driven by high investment, and enabled by access to an expanding global market. China was lucky since the new global production networks started to emerge in the 1970s allowed for entry into higher stages of the global value chain. However, external factors alone do not explain why China was unable to capture such opportunities earlier or why other countries were not able to seize the same opportunities. The previous discussion identifies three key relationships that help explain China's experience, namely the tension between domestic reform and international opening, economic and governance reform, and central and local governments. China's success over the last thirty years was built on striking a balance in each of these three tensions.

First, China built a virtuous cycle between domestic reform and opening up to the outside world. As a closed society for much of its history, there were huge gaps between China and

outside world in terms of levels of economic development, access to technology and information, etc. While opening up provided fresh new ideas and financing needed for reform, the vulnerability of a closed society made it difficult for a sudden and complete opening up, explaining why China's approach was gradual: starting with select sectors in coastal areas, learning from these experiments, and then expanding their scope. At the same time, huge differences between how domestic and international systems worked meant reforms were needed in order for opening up to succeed. The impact of such reforms often went beyond the narrow scope of those areas that are needed for opening up. Consequently a virtuous cycle was created in which the opening up required domestic reform, while further reform reduced gaps within and outside China, creating further room for opening up.

Second, China was able to maintain a delicate balance between economic and governance reforms. Analysis on China's reform process largely ignores governance, yet it was essential that such reform influenced the ideology and operation of government. The government continuously adjusted its goals and structure to satisfy the increasingly diverse demands coming from the economy and society, and in so doing, pro-actively maintained its position as the leading force for social and economic change. The government was also

mindful of the potential threats of change to the stability of the Chinese society, and strived to maintain the basic political structure and avoid “unnecessary” ideological debates.

Third was the careful balance between central and local governments. A great challenge in China’s development is the inherent contradiction between a unitary governance system and the great diversity in terms of geographic, economic, cultural, and societal conditions.

China’s reform and opening up needed the dynamism and creativity from bottom up, and a weakness of the central planning system was the total suffocation of local ingenuity. Yet local initiatives without reign could also mean chaos and waste, and Chinese history is full of lessons when too much local autonomy weakened central control and led to disintegration of the entire country. The challenge was to manage the central–local relationship. During most of China’s reform era over the past thirty years, the overriding theme was loosening up and giving more autonomy to the local government. Many successful reform measures and policies were based on initially local experiments, and local efforts were the major driving force of China’s economic development. At the same time, the central government has retained two powers that enforce its will on local governments, namely the power over appointments and promotion of local officials, and the control over major investments (Tsui

and Wang 2000). All industrial and infrastructure investment projects above a certain scale had to be approved by the central government, which helped monitor local investment but also created rent-seeking behavior by central government agencies.

Challenges

Despite the rapid rate of economic and social development in China since 1979, serious problems have emerged related to unfinished economic reforms; a growing civil society and widespread use of social media; environmental pollution and ecological damage; and adjusting to new global expectations.

Unfinished economic reforms. The remarkable growth of the economy over the last decades was partly due to the economic reforms that were started in the early 1980s. Recently there are concerns that the reform process has stalled, or worse is reversing. Many of the halfway, or temporary, reform measures have become de-facto fixed institutional arrangements that are now difficult to change, with various interests groups reliant on them now blocking continued reform. To continue the economy's healthy growth, these hurdles must be addressed and the

government must move forward with the necessary reforms in state-owned enterprises, investment, and taxes. First, although the share of SOEs in the economy has declined to 28 percent in 2008, these enterprises still benefit from non-market based advantages and should withdraw from competitive industries. Second, an investment-oriented development model driven by government is unsustainable. It has not only resulted in extremely high debt within the state's banking system, and twisted the natural process of technological choice and industrial development. The government should gradually withdraw from direct economic activities and strengthen the function of market regulation. Third, China must reduce the high tax burden on industry and improve the transparency of fiscal expenditure by local governments.

Civil society and social media. Despite the cautious attitude of government, civil society has grown rapidly. By the end of 2010, there were 431,000 registered non-governmental organizations in China, with over 5.4 million employees and ¥44 billion in donations (Zhang 2012). An ongoing challenge is to give these organizations more space to address various social problems, without eroding the authority of the government. In addition, widespread use of the Internet and the Weibo microblog have made it much easier for the general public to gain access to, and disseminate, information. There is an increasing demand for

government transparency and accountability from the general public, who are dissatisfied with the government's inability to address seemingly widespread corruption. The continuing revelation of corruption cases of high-level officials has severely eroded public trust in the government, and encouraged the use of social media tools to expose further cases of corruption. The general public is also increasingly concerned about the widening gaps of income among various groups and want more channels to express their interests and values in the policy making process.

Environmental pollution and ecological damage. Rapid economic growth in China was achieved at a huge price of environmental pollution and ecological damage, as loose environmental regulation made China a destination for pollution-intensive manufacturing. The annual losses incurred due to pollution may be as high as 5-10 percent of China's GDP, and nearly 358,000 people die from air pollution annually (Xu 2011). Since the 11th Five-Year Plan (2006–10), the central government has adopted environmental indicators in its evaluation of local government officials. However, the effectiveness of such a top-down approach is limited without a strong regulations and public participation, and widespread

problems with smog raise the question of whether the ecosystem can sustain China's continued development.

New global expectations. China's rapid development has generated international concerns about geopolitical changes, with some observers viewing the rise of China and emerging countries as a threat to the current international order, while others see the potential for a new system of global governance. Such debate will continue without clear answers, and Chinese leaders must assure the international community that the country's development will contribute to global peace and prosperity. Additionally, Chinese leaders face rising expectations from the international community to contribute to thorny issues of global governance, complicated by the fact that Chinese society has become an important force in shaping the country's foreign policy.

Prospects

The year of 2012 was an important turning point, with the 18th Party Congress and a new generation of leadership taking office, vowing to make China a well-off society by 2020.

Few doubt the determination of this leadership to fulfill this promise, and China has positioned itself to make the transition to a “higher quality” growth path. Education standards have risen dramatically, new green industries have emerged, the urban middle class is growing, and consumer living standards are increasing. One can confidently predict that the next five years will see the country become more sophisticated, more prosperous, with an older population, and a much more desirable living environment. At the same time, the challenges outlined above demonstrate the risks inherent in China’s development process, and China’s development could still derail if the government fails to provide for disadvantaged provinces, to curb corruption, to handle social unrest, or simply manage the complexity innate in such a large and diverse country. To manage these risks, China must continue the path of openness and reform Deng Xiaoping charted more than three decades ago; but this time embracing simultaneous political, social, and economic reform.

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¹ The Cultural Revolution, from 1966 through 1976, sought impose Maoist orthodoxy within the Party and enforce communism by removing capitalist, traditional, and cultural elements from Chinese society.

² "The Great Leap Forward," from 1958 to 1961, aimed to transform the country from an agrarian economy into a modern communist society through the process of rapid industrialization and collectivization.

³ The four Special Economic Zones (1980) and the fifteen Open Coastal areas (1984) not only imposed lower tax rates, but enjoyed a favorable institutional and policy environment to attract foreign investment.

⁴ The central government funds these programs in western and most central provinces, but requires wealthier coastal provinces to fund these same programs out of local fiscal resources. This further redistributes benefits from higher-to-lower income regions.

⁵ The concept of a Socialist Market Economy was first proposed by Deng Xiaoping to incorporate the market into China's planned economy. It was formally introduced by Jiang Zeming in 1993.

⁶ This ideology is credited to General Secretary Jiang Zemin and guided the CCP at its 16th Party Congress (2002). It states that the Communist Party of China should be representative of advanced social productive forces, advanced culture, and the interests of the overwhelming majority.

⁷ The Scientific Development Perspective is credited to Hu Jintao. It was first introduced in 2003 and guided the 17th Party Congress (2007).