

# Re-Interpreting the "Chinese Miracle": A Multi-Dimensional Framework

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*Das chinesische Wirtschaftswunder und die gesellschaftlichen Veränderung der letzten drei Jahrzehnte sind auf eine Vielzahl unterschiedlicher Faktoren zurückzuführen. Es mangelte an einem klaren Reformkonzept und einer Zielrichtung. Viele Maßnahmen entstanden zunächst spontan oder wurden lokal experimentiert und nachher von der Zentralregierung akzeptiert. Deshalb kam der Wandel teilweise geplant, teilweise spontan und teilweise fragmentarisch zustande. Die wirtschaftliche Entwicklung traf auf günstige Ausgangsbedingungen mit einer dezentralen Wirtschaftsstruktur und vielen lokalen Zentren, geringen Produktionskosten aufgrund billiger Arbeit und einem stabilen wirtschaftspolitischen Umfeld. Die Reformen wurden schrittweise eingeführt, so dass sich wenig Widerstand regte. Nach und nach gab es ein höheres Maß an wirtschaftlicher Freiheit, Rückzug der Regierung aus stark wettbewerbsorientierten Zweigen, schrittweise Öffnung der Märkte, allmähliche Zulassung von Privateigentum und Vertragsfreiheit. Positiv wirkten sich auch die weichen Faktoren wie die wirtschaftsfreundlichen Traditionen des Konfuzius, der Wille hart zu arbeiten und Bildung zu erwerben, aus. Problematisch sind mangelnder Arbeiterschutz, fehlende soziale Sicherungssysteme, Umweltverschmutzung und Korruption sowie Rückfälle in Dirigismus und Nationalismus. Beunruhigend ist das schwindende Bewusstsein für den Wert eines regelgeleiteten Wirtschaftssystems.*

## **Abstract**

The rapid economic development and transformation of Chinese society over the past three decades has, by a large mass of analysts, been called a "Miracle". This paper not only addresses the shortcomings of existing interpretations but also develops a new multi-dimensional framework based on North's theory of institutional change and Hayek's theory of institutional evolution to explain China's miraculous growth. Our analysis shows that both Hayekian spontaneous order and Popper's "piecemeal social engineering" played a major role in attaining China's miraculous growth.

## **Causes of China's Economic Success**

China became the world's no. 2 economic power measured by the size of GDP in 2010. It is widely regarded as one of the success stories of globalization. Analysts identify China's success in terms of high and sustained rates of aggregate growth and per capita national income, the absence of a major financial crisis, and a substantial reduction in poverty. They tend to view these results as the consequences of a prudent, yet extensive, program of domestic economic deregulation and global economic integration, as well as a sound macroeconomic management under the guidance by an authoritarian hand. The outcome of highly accelerated economic development has been frequently called the "Chinese Miracle".

However, the existence of a "Chinese Miracle" is surrounded by heated debates and controversies related to the understanding of China's rapid growth of the past three decades. China's success seems to have defied traditional models of economic growth, and social scientists have struggled to provide comprehensive explanations for the "Chinese Miracle". Indeed, most scholars focus their research on only one aspect of China's economic growth. One-dimensional explanations, such as comparative advantage of cheap labor, identify important contributors to China's economic accomplishment; yet it seems doubtful that any single variable affords an adequate understanding of the complexity of the causes. More likely, China's economic development was a result of numerous institutional factors.

A comprehensive scheme, including the interaction between factors such as institutional change and initial conditions, is needed to understand China's pattern of economic growth. These factors include not only the effects of initial conditions and social and market power, but also the roles of the government; not only the domestic causes but also international causes; not only causes related to factors of production market conditions, but also institutional arrangements and environments, formal or informal. A multidimensional framework — grounded in China's institutional environment — provides the breadth and complexity required to explain the country's economic success.

## **Building an Institutional Framework**

By reinterpreting the causes of China's growth, this article develops a new multidimensional framework based on institutional change. Institu-

tions refer to the rules of a society. They include both formal and informal constraints and the enforcement characteristics of both. The informal constraints consist of sanctions, taboos, customs, traditions, and codes of conduct. Formal rules include constitutions, laws, and property rights. Such various political, social, and legal-based rules affect production, exchange, and allocation. Changes in these sets of rules can lead to drastic economic shifts, as exemplified by China over the last 30 years.

The "Chinese Miracle" can be explained by focusing on this underlying institutional framework. According to Hayek, there are three kinds of institutional changes, and all played a part in China's development: first total construction-based institutional change, which corresponds to rules deliberately designed by a state or governing body<sup>1</sup>; second spontaneous change of institutions, which corresponds to rules that come into being spontaneously through the long-term cultural evolution<sup>2</sup>; and third piecemeal construction-based institutional change, which corresponds to rules formed through a combination of state design and evolutionary trial and error processes<sup>3</sup>.

In turn, institutional change comprises various factors. The most important components include: structural forces, institutional factors, political economy, people's choice, and elite choice. In China, these key components have interacted to create a set of favorable initial conditions, a relatively proper reform path, favorable informal institutions, ordinary people's pressures for survival, gradual approach to reform, and the existence of multi-action groups. Together, they represent one main feature underlying China's rapid economic growth: the liberation of productive forces from state planners.

- 1| Hayek, Friedrich A., von. 1978. *The Constitution of Liberty*. University of Chicago Press.
- 2| Hayek, Friedrich A., von. 1973. *Law, Legislation, and Liberty*. University of Chicago Press. 3. Hayek, 1978; Popper, Karl R. 1945/1992. *Die Offene Gesellschaft und ihre Feinde*. Band 1: *Der Zauber Platons*. Tübingen: Mohr (Siebeck). 7. Auflage.
- 3| Hayek agrees with Popper's piecemeal social engineering which allows for trials and errors, thus favoring the thought of piecemeal construction rather than total construction. See Popper, Karl R. 1945/1992. *Die Offene Gesellschaft und ihre Feinde*. Band 1: *Der Zauber Platons*. Tübingen: Mohr (Siebeck). 7. Auflage, and Hayek, Friedrich A., von. 1978. *New Studies in Philosophy, Politics, Economics and the History of Ideas*. London: Routledge & Kegan Paul.

## Favorable Initial Conditions

An economy's policy space and its performance are constrained by the initial conditions bestowed upon it by nature and an economy's past.<sup>4</sup> In China, favorable initial conditions include a decentralized, geographically multi-centered economic structure, multi-divisional form of organizational structure, low level of labor cost and regulation, and a favorable macro political and economic environment.

*Decentralized, multi-centered spatial economic structure:* The central government delivered a great deal of heavy-industry input to underdeveloped regions during the era of planning economy and encouraged self-sufficiency for each province. Much of the planning and management authority for economy and investment was delegated to provincial governments.<sup>5</sup> In practice, the central planner had created a decentralized, multi-centered economic structure as an unintended consequence of planning. This in turn created conditions for the regions to make use of their own talents and resources to compete with each other and develop after reform and opening-up began in 1978.

*Multi-divisional organization:* Enterprises in China prior to reform were of the multi-divisional-form organizational structure. This structure provided particularly convenient means for the central government to delegate part of the management authority of the state-owned enterprises to local officials in order for them to boost their motivation for management and development results. In contrast, the Soviet Union enterprises were mostly of the unitary-form where business enterprise was divided up according to function, not region.<sup>6</sup>

*Low level of labor cost and regulation:* Cheap labor is partly the result of China's catch-up strategy, where consumption was suppressed and investment was encouraged; light industries were suppressed and

4 | Ranis, Gustav. 1995. "Another Look at the East Asian Miracle." *The World Bank Economic Review*, vol. 9, no. 3: 509-534.

5 | Chen, Donglin. 2003. *The Construction of the Third-tier Region: The Development of the Western Region During the Period of War Preparation*, Publishing House of the Party School of the CPC Central Committee.

6 | Qian, Yingyi and Chenggang Xu. 1993. "Why China's Economic Reforms Differ: The M-Form Hierarchy and Entry/Expansion of the Non-State Sector." *Economics of Transition*, 1, 2, June, pp. 135-70.

heavy industries were encouraged; income for workers and farmers was dampened and much of the surplus of the industrial and agricultural production was transferred to heavy industries for the benefit of China's overall industrialization. There was ample labor supply in China but the capital supply was relatively scarce, which paved way for China to participate in the international division of labor. China's large pool of labor brought about foreign capital, along with advanced management skills and knowhow. For better or worse, China also continues to be one of the world's most lenient labor-market regulators.

*Favorable macro political and economic environment:* At the end of the Cultural Revolution, stability was a consensus of the political elite as well as the general population, despite their disagreements on the path of reform or the kind of reform. A favorable macro political and economic environment was thus created and maintained for over three decades in the name of stability and reform. The "Chinese Miracle" would be unthinkable without such a favorable environment, considered essential for foreign direct investment and business operation.

### **Relatively Proper Path of Reform**

Gradual reform and opening-up characterize China's path of reform. In particular, this includes early adoption of the path of least resistance, the selective stabilization of currency value, the gradual introduction of private property rights and competition, the adoption of an open market, the gradual approach to freedom of contract and the strengthening of personal and corporate liability, and ensuring the consistency and continuity of economic policy. Although this kind of step-by-step, selective opening up has been successful, it cannot be considered as the key point of the "Chinese Miracle". It liberated the productive forces to some extent, but limited further enhancement of resource allocation and thus further expansion of the production frontier.

*Adoption of path with least resistance at the beginning of reform:* Choosing the way of least resistance is in accordance with Nobel Laureate Douglass North's theory of institutional change that considers the historical evolution of institutions.<sup>7</sup> In China, the rural household re-

7| See: North, Douglass C. 1990. *Institutions, institutional change, and economic performance*, Cambridge University Press.

sponsibility system was initially started non-governmental and opposite to national government policy. It was a spontaneous order in the beginning, with deliberated design of some further rules among the peasants. They were afterwards recognized, modified and extended by the government as formal rules.

*Fiscal decentralization:* Fiscal contracts were introduced in the early 1980s between the central government and local governments across China, which increased the incentive for local governments to participate in and enhance local economic development. However, the strategic actions of local governments eroded central government's share of revenue in forms of the so called "hiding the wealth among people" and extra-budgetary and extra-revenue system.

*The dual-track price system:* Local state-owned and collective enterprises, even township and village enterprises, were allowed to be established. At the very beginning, the resources were under the control of state-owned enterprises. Later on, via the dual-track price system which lasted until the early 1990s, some resources were allocated to the market entities, as represented by township and village enterprises outside the state-owned enterprises, through exchange at higher prices. The dual-track price system emerged as a spontaneous order of transactions between the state-owned enterprises and township and village enterprises, induced by the profit opportunities in market for raw materials, resources, and goods. The central government attempted to tackle the transactions but in the end recognized them and thus the dual-track system.<sup>8</sup>

*Selective stabilization of the currency value:* The overall rate of inflation in China was relatively high before 1994. However, China chose to selectively stabilize its currency value by allowing foreign invested enterprises to possess foreign exchange certificates, which were convertible to foreign currencies. At the beginning of 1994, the new People's Bank Law and new Budget Law eliminated channels for the Ministry of Finance to borrow money or take overdraft from the Central Bank in

8 | Zhang, Weiyang. 2002. *Foreword: How the Dust Fell onto the Ground? In: Sheng, Zhaohan and Depeng Jiang, 2002. Evolutionary Economics. Shanghai Sanlian Joint Publishing House, p.15.*

order to control price increases. Fiscal surveillance thus matters in controlling price increases.

*Gradual re-emergence and introduction of private property rights:* Private property rights in China have evolved slowly. In agricultural production, the household responsibility system gave farmers land-use rights, but not private land ownership. During the early stages of reform, state-owned enterprises were the main land-holders. With administrative and fiscal decentralization, however, collective ownership through Township and village enterprises gained momentum and began to compete with state-owned property rights. Collective ownership had advantage over state ownership in that personal liability was more visible. By the end of the 1990s, township and village enterprises accounted for half of the country's industrial output, yet they continued to face similar soft budget constraints as the state-owned enterprises.

The spontaneous formation of individual industrial and commercial households and private enterprises in China represented the country's next step towards private property rights. Entrepreneurs in non-state owned enterprises were suppressed at the early stage but were then gradually recognized by the government. In the early 1980s, the rural cottage industries mushroomed, the rural and urban markets grew significantly and a large number of specialized small producers emerged. In 1992, the Communist Party put forward that economies under various ownership systems would be in a long-term coexistence with public ownership and they would develop together. From then on, China's private sector developed rapidly and in 1998 constitutional amendments gave legal status to private enterprises.

*Gradual introduction of market competition:* The "Chinese Miracle" is also related to the introduction of market competition. First, globalization brought in international competition, foreign capital, foreign management experience and technology. Hong Kong and Taiwan played an important role in this process. Secondly, competition between different domestic enterprises grew, forcing state-owned enterprises to compete both internationally and domestically.

*The unintended introduction of local government competition:* At the early stage of reform – after administrative and fiscal decentralization – local governments gained so called "regional property rights," which

incentivized them to develop their local economy<sup>9</sup>. Local governments began competing for resources and market. This competition was an unintended consequence of the decentralization, yet it was beneficial to China's economic development.

For example, the local governments would add benefits for foreign investments beyond the tax benefits central government had agreed to in order to attract foreign investments. Or the local governments would increase subsidies for foreign investments in violation of central government's uniform requirements. Additionally, competition among local governments resulted in the privatization of local business. However, the competition also had some negative, unintended results. There were many complaints that, in their efforts to outbid each other, the local governments were giving too many concessions to the foreign investors.

*Selective and gradual opening of the market:* Ever since the reform process began in 1978, China has gradually opened its foreign capital and domestic capital market and made use of the international market, including selectively opening some regions. Selective opening of the market has promoted the competition between enterprises with different types of ownership, and helped improve the efficiency of the economy as a whole. Additionally, export-orientation facilitated the use of China's comparative advantage in the international division of labor.

*Gradual enhancement of freedom of contract:* In the planned economy period, there was no freedom of contract; the unified deployment of resources by the government did not solve the problem of innovation, nor did it efficiently utilize dispersed knowledge within the economy. Economic reform and opening-up has made social forces and market actors organize production and exchange in a better way in order to achieve division of labor and knowledge<sup>10</sup> via voluntary contracting, which created more wealth. Gradual introduction of private property rights also made a great number of complex contracts possible.

9| For "regional property rights", see Granick, David. 1990. *Chinese State Enterprises: A Regional Property-Rights Analysis*. Chicago University Press, and Herrmann-Pillath, Carsten. 1999. "Die fiskalische und regionale Dimension des systemischen Wandels großer Länder: Regierungswettbewerb in China und Rußland." *Wittener Diskussionspapiere*, No. 42 (September).

10| Hayek, Friedrich A., von. 1973. *Law, Legislation, and Liberty*. University of Chicago Press.



*Strengthening individual and corporate liability:* Privatization, marketization and the emergence of the private sector enhance private property rights. The latter means also a process of strengthening individual and corporate liability. The gradual introduction of property rights and freedom of contract has also laid a foundation for strengthening and enforcing the individual and corporate liability, which can provide positive impetus to economic growth.

*Consistency and continuity of domestic and foreign economic policy:* Since the beginning of reform, government authorities have selectively provided a relatively stable policy environment to foreign investments. For larger domestic private enterprises, economic policy and regulations have also been relatively stable and consistent. However, for small enterprises, especially in select industries — the government has enacted a force-out policy.

The above reform approaches, no matter if they involved government-led design or emerged spontaneously, rendered in general a higher degree of economic freedom and allowed market actors a larger free space. In addition, there were also some attempts by the government which reflected a total construction approach but proved unsuccessful. Some reforms, such as the success of the rural household responsibility system, brought about supportive "momentum effects" fueling further reforms. Furthermore, the government chose to withdraw to a certain extent from the most competitive sectors of the economy, freeing up space for entrepreneurship. At the same time, many reform approaches as mentioned above appear to be government-led, but in practice their results happened due to factors both inside and outside of government control.

### **Advantageous Informal Institutions**

There are informal institutions that are advantageous as well as informal institutions that are disadvantageous to the development of Chinese economy. The informal institutions and pressure for survival that had been working from before the Chinese revolution are beneficial for economic growth in China.

*Tradition:* The tradition of Confucianism in the Chinese culture and society, as an informal institution, is beneficial for the industrial and commercial development. Confucianism is not in favor of politicians and

government officials to do business, but does not prevent the ordinary people from doing so and since the ancient times the Chinese have attached great importance to commerce.

*The pursuit of a better life:* Chinese people, just like people everywhere else, have always been in pursuit of a better life. This drive is a kind of informal institution in itself and would help bring into play the Chinese entrepreneurship. This attitude among the Chinese people, expressed through commercial culture, was suppressed under the planning era, but it has been acting as a motivation for wealth creation after the reform was initiated.

*The tradition and attitude of being flexible, hard working, and entrepreneurial:* Pressure to survive harsh living conditions and the pursuit of a better life have made the Chinese people flexible, hard working, and entrepreneurial. Historically, severe living environments affected people's behavior and helped to shape their hard-working and pragmatic attitudes. After the 1978 reforms, these mindsets proved beneficial for local economic growth.

*Traditional emphasis on education:* The Chinese people attach great importance to children's education, with much attention to learning by doing. This tradition has formed a well-trained labor force and a significant community of Chinese entrepreneurs. A pro-education tradition, as well as the pursuit of a better-life, created an informal institutional basis for a large number of private entrepreneurs to emerge, particularly after 1978. Pressure for individuals to survive economically and the extension of the government's permission to form private businesses further promoted entrepreneurship.

### **The Gradualist Approach to Reform**

China is often cited as the leading example of a successful gradualist approach to transition away from a planned command economy. Unlike the economies of many former communist countries in Eastern Europe that underwent rapid and radical reforms, Chinese reform was characterized by gradual, experimental, phased and partial reform. It was a transition without design, appropriately described by the famous slogan "crossing the river by feeling the stones." China has experienced a lengthy process of readjusting reform objectives from "a planned econ-

omy with some market adjustment," to "a combination of plan and market," and then to "a socialist market economy".<sup>11</sup>

This approach is a double-edge sword. On one hand, gradual reform is beneficial for political, economic, and social stability, and allows for the development and evolution of informal institutions.<sup>12</sup> On the other hand, gradual reform allows actors with vested interests to impede the process of reform; the stronger the vested interests, or the more of them, the greater the resistance. Additionally, gradual reform itself can be used as an instrument for corruption. Gradualism generally means marginal breakthroughs in changing existing rules or policies, and that kind of breakthroughs often involves rent-seeking. Interest groups are able to provide benefits to government officials in exchange for receiving more rent.

Moreover, the choice of gradualist reform is related to the lack of consensus among decision-makers. Most top-down reforms in China had the pattern of "first experiment and then extend it," and they did not reflect the government's intention to reform and improve, but rather to preserve the stability of political regime and to protect personal interests. Bottom-up reforms often adopt a "first do it and then be recognized" approach. These reforms often first happen locally and spontaneously. After becoming a performance benchmark, they apply reversed pressure on the decision-makers to gain legitimacy and eventually be formally recognized, thus providing a basis for their further enforcement. The introduction of rural household responsibility system, dual-track system and private property rights are of that type.

Many top-down reforms are also of the "first do and then recognize" approach. Often the experimental units are first permitted at the boundary of the legal system and then the achievements are recognized (or denied) and furthered by the government. Such reforms include the reform of state-owned enterprises and township collective enterprises.

11 | Fan, Gang. 1994. "Incremental Changes and Dual-Track Transition: Understanding the Case of China." *Economic Policy*, vol. 19 (December 1994).

12 | This is opposed to shock therapy, which tries to change and adjust informal institutions overnight.

### **Multi-action Groups to Promote Reform and Development**

Reforming an entire economic system entails reforming several sub-systems, all of which affect a variety of stakeholders. Such system-wide economic reform requires support from numerous action groups and therefore is neither a top-down nor a bottom-up process. In the Chinese context, both people's choice and elite choice played roles in the overall reform process.

In the case of rural household responsibility system reform, mainly the survival pressure led 18 peasants in 1978 from Xiaogang village of Fengyang county in Anhui province to take risks, sign an illegal agreement to break up the collective-owned land into plots which were to be farmed by individual households, and spontaneously organize and implement the fixing of farm output quotas for each household. Such a spontaneous solution boosted up enormously the grain production by these households. The phenomenon then spontaneously and rapidly spread without an outside plan or design. After the reform and opening-up, the household responsibility system was formalized and extended with the recognition of the government and hence became an external piecemeal construction-based order. Therefore, the innovative peasants of Fengyang and those who imitated them were the primary action group and the government became the secondary action group in this reform.

No doubt, the government also played an important role as an action group in China's broader economic reforms. Examples of such reforms include fiscal and administrative decentralization, preserving a stable currency and consistent foreign economic policies, gradual introduction of private property rights and competition, selectively opening the market, gradually introducing freedom of contract, strengthening individual and corporate liability, and the *xiaohai* ("go down to the sea") policy that encouraged individuals to quit their governmental jobs to start their own business or work in business sectors. When the government opened up the market, introduced competition, and exited from the competitive sector to some degree, it was the private actors within the economy that gained broader space for free development and promoted the economic growth leading to the "Chinese Miracle".

### **Conclusion: Problems and Prospects for Reform**

Favorable initial conditions, a relatively proper reform path, favorable informal institutions, pressure for survival, gradual approach to reform, and the existence of multi-action groups are they key variables that constitute the underlying causes of the "Chinese Miracle". It is important for China to continue to adopt and improve the set of institutions that have proved successful for maintaining rapid and sustained economic growth and development.

There are, however, several problems in the Chinese reform process, including lack of labor protection and social securities, severe pollution, violation of famers' land rights, severe corruption, regional income disparities, and the potential risk of macro-economic instability and financial crisis (as a result of over-borrowing and misallocation of financial resources). Further reforms in China face great difficulties in dealing with core institutional problems, such as preserving the land rights of farmers, breaking up the state monopoly by state-owned enterprises (including the state-owned commercial banks), developing competitive markets, and preventing the government from intervening in the micro-economic processes. In order to solve these problems, constitutional reform is necessary to limit government power and safeguard individual rights.

There have been a reemergence of economic thought and policy of populism, statism, nationalism, as well as dirigisme in the past several years. As a result the economic freedom of individuals and enterprises, as the basis of "Chinese Miracle", is being eroded. The examples are numerous. The entrepreneurs' property rights are frequently violated, and the sound economic principles of fiscal and monetary discipline are being gradually undermined. For instance, the National Development and Reform Commission of the State Council — together with the Central Bank and the China Banking Regulatory Commission — now decide credit policies, which should be decided independently by banks.

Moreover, the government sets industrial policies as policy priorities, rather than competition policies. Transfer payments and subsidies have deepened individual and local dependence on the central state and many people are losing their economic independence. Yet the erosion of formal rules and institutions is not the worst of it. More discouragingly, public awareness of the importance of having a rule-oriented

economic system is losing ground. After losing these kinds of informal institutions, it may take several decades to reshape them, if that is even at all possible.

If China does not provide better property rights protection, it could lose a favorable investment environment and a competitive market order that enabled the fast growth and development during the recent decades. The cost of doing business for enterprises would inevitably increase, and the technical innovation and industrial upgrading would lag behind. As a result, the "Chinese Miracle" would end much earlier than expected.

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