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**with a focus on China**

**China – Development in Progress,  
How a shift in the Political System is  
Changing China’s Economic Path**

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*Key words: Federalism Chinese Style, WTO, Household Responsibility System, Open Door Policy, Deng’s Southern Tour, Decentralization, Private Sector, Development, Reform, Bottom up Reform, Grassroots Democracy*

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## Abstract

This paper is arguing that China’s political and economic opening in 1978, also referred to as China’s open door policy, was initiated by a change within China’s institutions affecting the political as well as the economic system. Since the opening in 1978 up until today (2012), constant economic reforms and developments as well as political progress can be observed. Domestic examples of China’s political and economic developments can be found by looking at the increase of property rights, the establishment of a private sector economy, the development of a democratic system on the grassroots level for village elections, the increase in the Human Development Index (HDI) and the massive reduction of poverty. Global examples can be seen in the fast increase in China’s total trade volumes since 1978 and the interconnections of the global and the Chinese marketplace, as well as China becoming the second largest economy worldwide and its joining the World Trade Organization (WTO) in 2001. All these developments can be traced back to institutional progress in the political sector, setting off a process of liberalization, also referred to as “*Federalism Chinese Style*”, which directly correlates to China’s rapid economic growth.

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## Abbreviations

|       |  |
|-------|--|
| CCP   | Chinese Communist Party                |
| COE’s | Collective Owned Enterprises           |
| CR    | Cultural Revolution                    |
| FDI   | Foreign Direct Investment              |
| FOF   | Foreign Owned Firms                    |
| GATT  | General Agreement on Tariffs and Trade |
| GDP   | Gross Domestic Product                 |
| GLF   | Great Leap Forward                     |
| HDI   | Human Development Index                |
| HRS   | Household Responsibility System        |
| IMF   | International Monetary Found           |
| IPR   | Intellectual Property Rights           |
| JV’s  | Joint Ventures                         |
| PPP   | Purchasing Power Parity                |
| PRC   | People’s Republic of China             |
| SAR   | Special Administrative Region          |
| SEZ   | Special Economic Zones                 |
| SOE’s | State Owned Enterprises                |
| TVE’s | Township Village Enterprises           |
| WTO   | World Trade Organization               |

## Introduction

The purpose of this investigative study is to explore the validity of the following research question: is there a relation between the liberalization of China’s political system, which shows grassroots democratic development, and its economic growth? This paper assumes that a democratic political system is enhancing economic growth and that China’s economic success can partly be linked to a gradual reform process in both the political and the economic field since the beginning of the open door policy in 1978, also known as “*Gaige Kaifang*”.

Over the course of the last 5000 years, China has been a driving force of key innovations and developments, which include scientific breakthroughs in almost every field and range from the discovery of gunpowder to the development of the compass. The only thing Mainland China has never experienced was a political system appointed by the Chinese people. Instead several different emperors ruled China. The last three dynasties ruling China were the Yuan Dynasty, which ruled China and Mongolia from 1271 to 1368, the Ming Dynasty which controlled China from 1368 to 1644, and the Manchu Dynasty, which lead China from 1644 to 1912. The People’s Republic of China was declared on October 1<sup>st</sup> 1949 under the leadership of Mao Zedong and has since been under the control of the Communist Party. It took the Communist Party 28 years to gain full control of Mainland China after defeating the Kuomintang during the Chinese civil war (1927-1949). Mao Zedong’s dictatorship isolated China economically and led to the Great Leap Forward<sup>1</sup> (GLF) from 1958 to 1960 as well as to the Cultural Revolution<sup>2</sup> (CR) from 1966 to 1976, in which millions of Chinese citizens were victims (Grivoyannis, 2012, pp. 1-25).

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<sup>1</sup> The Great Leap Forward (1958 – 1960) was initiated by Mao Zedong and followed a system that “*emphasized decentralization of ownership and decision-making by communes while it ideologically tried to inspire higher productivity across all sectors of the economy*” (Grivoyannis, 2012, p. 2). This led to the collectivization of farms and a labor-intensive industry. The shortage of capital and bad weather conditions drastically reduced the food production, which resulted in the biggest manmade famine in history killing 45 million people from starvation.

<sup>2</sup> In the ten years of the Cultural Revolution (1966 – 1976) universities were closed and members of the Chinese People’s Liberation Army replaced company managers and engineers, which led to inefficiency within the economic sector. In addition to this foreign technology was no longer imported which further reduced economic growth. Roughly 2 million people were declared as enemies of the new established communist system and were killed by Moa Zedong’s movement of the Cultural Revolution (Grivoyannis, 2012, p.4).

China’s economy was and can be characterized as a centrally planned economy, which was orientated towards heavy industry and large collective farms. Key characteristics of this economic system included a distorted macro-policy environment, which is known for low interest rates, an overvalued exchange rate, low minimal wages as well as low prices for living necessities such as basic food.

During this time period, a private sector did not exist and all industrial and agricultural production sites were state-owned or under state control, this is referred to as collective ownership. One of the consequences of this included low levels of performance efficiency across the entire economy. It was not until 1978 that China initiated economic reforms, which allowed for economic development and laid the foundation for the re-entering into the world economy and gave rise to China’s accession to the World Trade Organization in 2001. It were these economic reforms, which led to the biggest poverty reduction in history and would allow China to become the second biggest economy as measured by gross domestic product (GDP) based on PPP (IMF, 2012, GDP rankings).<sup>3</sup>

Due to China’s remarkable economic developments since 1978, China’s impact on the global economy has increased dramatically, demanding the world’s attention. When the Chinese government announced current GDP growth figures, industrial production levels, saving rates and the new 5-year plan, the news spread rapidly, thereby influencing global stock exchange markets and commodity prices. Additionally, the announcements of new policies, directed towards the Chinese central banks monetary system created almost more attention than similar statements made by America’s Federal Reserve (The Economist, 2012 a). Furthermore, proclamations made by the Chinese Prime Minister Wen Jiabao, which underline the country’s need for further economic growth, impact international markets to a greater extent than statements made by any European leader. All this underlines China’s new, “old”, role as a key decision-maker directing international development (The Economist, 2012 b).

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<sup>3</sup> However, if measurements in GDP (PPP) per capita are taken under consideration, then China has managed to increase from \$250.871 (current international dollar, July 2012) to \$9142.668 (current international dollar, July 2012) (IMF), which is equal to an increase of its worldwide ranking from 119 in 1978 to 75 in 2012 (NationMaster.com, 2012).



The origins of economic development in China include the following:

1. *The ability of entrepreneurs to move goods from a region of low demand to a region of high demand.* The increase in marginal utility leads to an increase in price, shifting the decision making from the state or collective to the private sector economy. The first economic boom in China after 1978 can be traced back to the entrepreneurs’ ability to move goods and therefore generate a higher marginal utility. By doing so entrepreneurs were able to charge a higher price and increase their profits. This was a very important step and considering the fact that China still is a communist country these developments become even more remarkable.
2. *Improvement of infrastructure and the resulting decrease of transportation costs lead to an increase in profits.* Due to the improved infrastructure, the expansion of the market place to rural regions became possible.
3. *Change and progress of property rights.* Redefining property rights increased the incentives for innovation and further economic developments, as the risk of expropriation was reduced.
4. *New production technology reduced production costs.* The acquisition of new production technology was made possible through Special Economic Zones (SEZ) and the channeling of foreign direct investments (FDI) through SEZ.
5. *Decrease in transaction costs, supported through export oriented growth and the expansion of the Chinese market space to a global level through China’s accession to the World Trade Organization (WTO) in 2001.*
6. *Utilization of capital and resources as a direct result of technological developments and the rapid increase of GDP per capita.*

Other factors, which also positively impacted China’s economy, include an increase in the quality of education, health, and rising life expectancy.

Despite China’s economic success little has happened politically (Nee et al, 2012). Today the only successful democratic system in China is Taiwan. Not even Hong Kong qualifies as being democratic even though political elections are held and censorship is comparably lower than it is in Mainland China. Truly free elections, in which the political opposition has a fair chance of winning and forming a new government would never be accepted by the Communist Party, thus making Hong Kong a “*pseudo-democracy*” as characterized by

Diamond et al. (2001, p.4). Even though Mainland China is not democratic, it still has democratic institutions on the village level in form of village elections, which is also known as grassroots democracy (Perry et al., 2007).

The first chapter of this paper focuses on “Federalism Chinese Style”, which is used to present a theoretical background for the economic developments made in China. It argues that, the Chinese development has almost entirely been in the economic sector and that little has changed since 1978 in the political sector, as China’s political developments have almost entirely been compared to China’s development towards democracy. This comparison gives a distorted picture because China’s political system, a one party totalitarian regime, is still essentially the same as it was three decades ago but nevertheless China has developed strong characteristics of a market economy.

The second chapter of this paper evaluates China’s institutional and political reforms made since 1978 and differentiates the reform process first in grassroots reforms and then in central government reforms including enterprise reforms and how each of them has affected China’s economy. Have developments towards democracy been made in China since its opening and if so how have they affected the economy?’ is the central question of the third part of this chapter.

In the third chapter, this paper concentrates on the link between political, civil, and economic liberty and economic growth in China. It argues that China’s economic success can be characterized as a bottom-up gradual and evolutionary process in which the government had no such thing as a blueprint for China’s developments. The fourth part of this paper, analyses China’s accession to the World Trade Organization (WTO) in 2001 and how this has affected China politically and economically. It finds that the WTO accession can be seen as one of the final steps made to reintegrate China back into the world economy and laid the foundation for further economic developments, which might lead to a shift in China’s political environment.

The final chapter concentrates on China’s current and future direction of economic growth, political reforms and upcoming challenges using the results obtained from interviews conducted in Mainland China and Hong Kong.

## Methodology

This Master thesis was written on the basis of primary and secondary research. Secondary research is based on a thorough analytical review of leading literature relevant to the topic of this study, whereas primary research was conducted in the form of interviews. The literature includes political science publications, economic literature, especially with regard to economic development theory and institutional economics, as well as publications of other academic fields including historic reviews. Thus, this investigative study is a qualitative analysis of secondary research, as it draws on the knowledge of both practitioners and academics alike. It should be acknowledged, however, that interpreted data includes academic journals as well as articles from the popular press and formal/informal government publications. Simultaneously, graphs and figures have been used to highlight as well as illustrate theories. Additional figures and information can be found in the appendices, which include timelines of important events that impacted economic development. Quantitative data have been used in the form of growth and development statistics to highlight main arguments throughout the thesis. This statistical data was collated from the United Nations, the World Bank, the International Monetary Fund, as well as the World Trade Organization.

The primary research within this thesis constitutes of interviews conducted in China in April 2012. Interviews were conducted with six different managers (Chinese and foreign) in Shanghai, five managers in Hangzhou and two managers from Hong Kong. A detailed report and analysis of the interviews and the consequent results can be found in the 5<sup>th</sup> part of this thesis. The interviews were conducted in an informal style in which only the first question was similar in all interviews: *“What kind of challenges do you see for China’s economy in the next five to ten years?”* This allowed the interviewees to start with what they perceived as the most important challenges based on their own experience from doing business in China.

The limitations of this thesis include time and space constraints of the interviews, which limited a much-wanted thorough discussion about each event mentioned within an interview. At the same time, this thesis had to be kept considerably short, due to the prescribed word limit. Therefore, the extensive investigation into China’s economic development and political reform process does not receive the attention, which it would be entitled to. Further research

in this field is necessary in order to fully comprehend the complexity of China’s political and economic developments. Also, not all aspects of China’s development could be included. In combination with limited access to data this may leave room for misinterpretation.

# 1. Theoretical Background – Federalism Chinese Style

Since the publishing of Montinola et al. (1995) paper “*Federalism, Chinese Style – The Political Basis for Economic Success in China*” much has changed economically in China. While several issues in the economical and political sector have been addressed, others remain almost unchanged. The political system for instance has not changed, as China is still a single-party state extremely intolerant of any political opposition, making political development away from the current status quo unlikely in the near future. At the same time, the economic sector followed a different path. Since China’s beginning of the open door policy (1978), continuous economic reforms allowed the economy to develop and integrate into the global marketplace, which include China’s accession to the WTO (2001), improved property rights, and an increasing private sector. All of these developments were unthinkable prior to 1978. Thus, Montinola et al. (1995) observation that the economic reform process appears to have been successfully implemented without significant political reform still holds.

However, looking at China’s political reform process under the narrow definitions of development, a rather distorted picture surfaces. While it is true that the Chinese people have no access to basic human rights, which include individual rights, free speech, and an independent court system, the rule of law and other formal aspects of democracy have not been further developed. China’s political reform process is often compared to how China has been progressing towards democracy (Diamond et al. 2001; Gilley et al. 2008; Perry et al. 2007), but as Montinola et al. (1995) rightly have pointed out, that democratization does not include all the different aspects of political reforms.

Reflecting on China’s political developments towards becoming more democratic, little change can be seen, whereas China’s overall political climate has changed immensely. First, political decentralization directing more authority to the local government and shifting the political relations between the local and the central government can be seen. Second, a shift in ideology has occurred - allowing China to move away from the ideas installed under Mao Zedong - with a greater focus now given to the free market. This becomes especially clear when looking at the most recent 5-year plan. Examples of these developments include the increasing acceptance of a private sector economy (even though opposition still exists),

Deng’s Southern Tour of 1992<sup>4</sup> (in which he promoted economic liberalization), the increasing political power of the local government, as well as China’s WTO accession (2001). Third, the fact that China, despite being a communist country, committed itself to an open economy, allowing for strong economic developments which enabled the economy to grow an average of around 10 percent since 1978 must be acknowledged (Naughton, 2007).

While some of these developments are limiting the power of the central government, they are additionally creating a solid political foundation for further reforms, in both the economic and the political sector. Chinese federalism and Western federalism share similar characteristics, which include the division of power between the central and local government, enabling the local government to control the economy within their jurisdictions and thereby allowing durability within the political system (Nee et al., 2007). Granting the local government more independence shows a large amount of commitment of the central government, as these types of reforms are not only difficult to implement but additionally costly to reverse. Therefore, a long-term commitment towards economic reform is indicated. At the same time however, it is important to understand that the Chinese system consists of a different form of federalism than the Western system, which is also characterized as “*market-preserving federalism*”. This is due to the fact, that China has not been able to create a domestic common market. This failure has led to the creation of trade barriers as well as a strong anti-market policy from local governments (Wong et al., 1987). Secondly, the decentralization within the political sector has not been institutionalized, which would support long-term economic stability (Naughton, 2007). Thirdly, even though property rights have been progressing they are still extremely weak in comparison to Western standards. Despite these problems China’s economy has undergone tremendous change and was able to expand and advance to the second largest economy in the world. As Montinola et al (1995) succinctly puts it:

*“The fundamental feature of federalism is decentralization; however not all systems of decentralization are federal. To understand federalism, we must identify its principal characteristics. As a special type of federalism, market-*

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<sup>4</sup> In 1992, Deng Xiaoping traveled through southern China promoting the importance of economic reforms at the same time as he was criticizing those who were standing in the way of further economic reforms. One result of his tour was the broader acceptance of the private sector, which as a result lost its stigma as being capitalistic. Later this tour became also known as “the Southern Tour”, or “Deng’s tour”.

*preserving federalism encompasses a set of conditions that governs the allocation of authorities and responsibilities among different levels of government:*

*F1. A hierarchy of governments with a delineated scope of authority (for example, between national and sub-national governments) exists so that each government is autonomous within its own sphere of authority.*

*F2. The sub-national governments have primary authority over the economy within their jurisdictions.*

*F3. The national government has the authority to police the common market and to ensure the mobility of goods and factors across sub government jurisdictions.*

*F4. Revenue sharing among governments is limited and borrowing by governments is constrained so that all governments face hard budget constraints.*

*F5. The allocation of authority and responsibility has an institutionalized degree of durability so that it cannot be altered by the national government either unilaterally or under the pressures from sub-national governments.”*

These conditions build the institutional foundation for market-preserving federalism, thus restraining the impact of the political system on the economy. When evaluating these five conditions one can categorize them into two different groups: the first group is condition number 1, which defines the characteristics of federalism, whereas the second group consisting of conditions 2, 3, 4 and 5 is needed for guaranteeing federalism’s market-preserving qualities. As such market-preserving federalism creates the basis for markets to develop by reducing the influence of the central government. The transformation of political power from the central to the provincial or even local government promotes economic success by reducing the risk of political disturbances created by the central government, which could impact economic development. Therefore, the key idea behind market-preserving federalism is to allow the market to operate with as little influence as possible from the political sector. This additionally implies an increasing degree of competition from one province or region to another, therewith forcing each of them to become more efficient. This causes some regions to perform better than others in supporting the market and the citizens. However, since some of the better working policies are being duplicated by less successful regions equal

development will be unlikely. This is partly due to different demands from different industries, which include raw materials, infrastructure, general access to the market, as well as a difference in the bargaining power and size of the labor force. The 3<sup>rd</sup> condition of market-preserving federalism indicates that a common market would only be possible and functional if the different regions agree to an open market policy without trade barriers. This would have to be under the control of the central government. If central control is not achieved, then regions, which suffer from increasing competition, are more likely to establish trade barriers. Therefore, threatening the idea of the common market, as regions have gained more independence on different levels their rate of development is increasingly dissimilar. This however does not fulfill the conditions needed to give rise to a common market.

A further challenge to the concept of a market-preserving federalism is the unequal distribution of centralized control over the monetary system (Krugman, 1991). One risk of not having a centralized monetary system lies with the difference between inflation levels. By supplying the local government with too much money, inflation levels would increase, which in combination with the local government’s easy access to short-term borrowing, creates a soft budget constraint.

*“The state must also commit to negative market incentives that punish economic failure; if the government is tempted to bail out failed projects or continue costly inefficient public programs, individuals have no incentives to avoid mistakes and waste”* (Qian et al., 1997).

North (1990) characterized this as the “*state predation*” problem, which declares that the state must show commitment to negative incentives for a market that strangles economic underachievement. One way of doing so is by generating an incentive to avoid mistakes. This can be simply created from the government by stopping to bailout failing projects, as well as terminating expensive and inefficient public programs, which is also known as the “*soft budget constraint*” problem (Kornai, 1986). With a soft budget constraint, efficiency is likely to decrease due to the opportunity of a bailout, which leads to an even further decrease in efficiency, while expanding the risk of moral hazard. China’s “*federalism Chinese style*” and federalism known from Western countries are different in a variety of ways as noticed by Montinola et al. (1995):



*“First, the latter virtually always roots federalism in an explicit system for protecting individual rights. Second, Western federalism typically has strong, explicit constitutional foundations. Third, it is almost always associated with political freedom, representation, and democratization. None of these factors are present in China. Notice, however, that as defined above, market-preserving federalism in no way depends on these factors. Instead, it depends on the political relationship among levels of government, with no reference to an explicit or constitutional basis or its promotion of individual rights and political freedom.”*

One of the most important reforms of the central government was its move towards decentralization and with that the shift of authority to the local government. The idea of decentralization emanated in China during the Great Leap Forward (1958 - 1960), and the Cultural Revolution (1966 - 1976). Nevertheless, the decentralization of the 1980s had its own distinctive characteristics, which included a bundle of financial incentives, increased authority of the local governments over economic decisions in combination with China’s increasing integration into the global economic market place (Yingyi et al., 1993).

Prior to China’s open door policy the economy was not entirely controlled by the central government. In fact within the different industry types, especially with regard to light and heavy industries, less than 50 percent of all industrial output was controlled by the central government, indicating that the majority share was controlled on the local government level (Wong, 1987). As a direct consequence of reform processes between 1978 and the early 1980s a large amount of SOE’s, which were previously under central control were passed on to the local government. As a result only 20 percent of SOE’s in 1985 were under the control of the central government, while an increasing majority of these were situated under the control of the local governmental (Qian, 1993).

The establishment of four Special Economic Zones (SEZ’s), as also indicated by figure 1, Shenzhen, Zhuhai, Shantou and Xianmen in 1980 fits right under the umbrella of federalism Chinese style. The SEZ’s benefited from the decentralization of authority through receiving special status in terms of economic development, such as lower tax levels and easier access to land and property, as well as other favorable business conditions in order to attract FDI and with that new technology (Wall et al., 1996, pp. 1-53). As the Chinese government was still anxious about authorizing foreigners and FDI back into China after decades of occupation,

they saw the SEZ’s as an experiment. The idea was to expand the SEZ’s if they proved to have a positive impact on the Chinese economy. Thus, the establishment of the four SEZ’s enabled the adoption of free market-oriented economic policies and flexible government measures. As a result of these economic developments, poverty decreased from roughly 65 percent to approximately 4 percent of people living below \$1 a day (Chen, Ravallion, 2007), and therefore increased the Chinese Human Development Index (HDI<sup>5</sup>) (World Bank 2012).

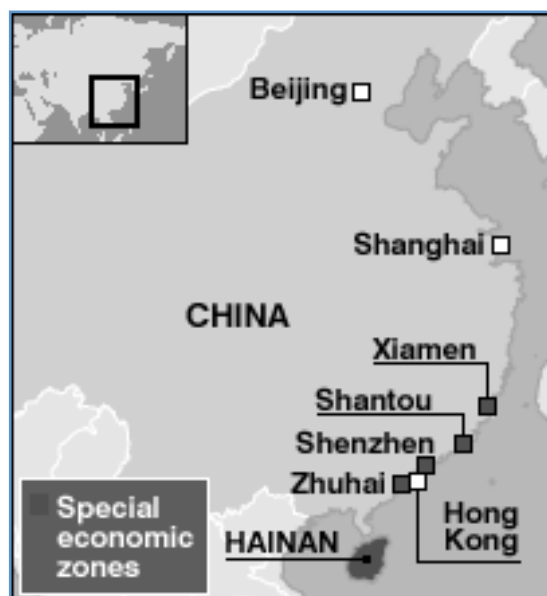


Figure 1: Map of China’s SEZ (BBC News)

Since the initiation of the reform process in 1978 federalism Chinese style has developed to such an extent that a reversal is becoming increasingly unlikely. Indications for this include the following:

1. As a direct consequence of the decentralization process, local governments, especially those that have displayed strong economic growth, have become more independent from the central government. This strong economic growth and independence can be traced back to the increase in authority, political support and the ability to generate revenue.
2. The declining influence of the central government on the local government due to an increasing independence of the local government (as indicated in 1.).
3. An increasing and largely expanding private sector, which makes it progressively more difficult for the central government to monitor the market.

Each of these points shows the increased cost of reversing the economic as well as political developments (Naughton, 2007; Montinola et al., 1995). These developments limit the central governments control over the economic sector; increase competition between the governments, while increasing the incentives of creating local economic well-being. A vital

<sup>5</sup> The Human Development Index (HDI) is a complex statistic, which is used as an indicator for living standards by the United Nations.

part of the successful implementation of these developments included China’s willingness to restructure its political institutions. Even though progress can be seen, China’s economic and political reforms are far from being completed, especially in comparison to Western standards. Nevertheless, it is possible to state, that increasing living standards, HDI, as well as the accumulation of wealth can be directly linked to China’s reform processes.

### **An overview of China’s reform process within the bureaucratic sector**

The overhaul of the bureaucratic sector was highly significant for China’s further development and became a key part of the development process.

- Updating and modernizing the bureaucratic sector, away from the old communist ideas established under Mao Zedong (essential in order to effectively install and underline the new ambitions towards new policies of economic growth).
- As a result of this, the administrative reforms throughout the 1980’s became more precise and transparent (Opper, 2011), which lead to a higher predictability of bureaucratic decisions and therefore reduced uncertainty of economic planning.
- At the same time, the government implemented strict retirement ages for government officials, as well as a one-time buy-out strategy to retire old officials with the idea to further push towards market-oriented reforms (this could be slowed down by old Maoist bureaucrats).
- Replacing old officials with new personnel allowed the reform process to move forward and prevented progress from being stuck in old commitments to the outdated planning mentality of state socialism.
- Introducing merit based entrance exams for job applicants for the public sector and also clear promotion schemes, which led to a rapid increase in average education levels and university graduates.
- *“China’s policy of fiscal decentralization has constituted a key institutional innovation aimed at strengthening economic incentives of municipal and provincial governments to support market-oriented economic reform.*
- *According to the fiscal revenue-sharing system, lower-level governments have the obligation to submit a fixed proportion of fiscal revenues to their superior government unit, while retaining the residual for their own budget.*

- *Given that tax revenues are positively correlated with firms’ performance, bureaucrats have an incentive to do what they can to assure that local firms prosper (Montinola et al., 1995; Li, 1998).” (Oppen, 2011)*

To summarize these developments, the strong will coming from within China’s bureaucratic system must be acknowledged. It developed and allowed a new era to emerge by adjusting its own policies towards a more open and transparent political and economic system.

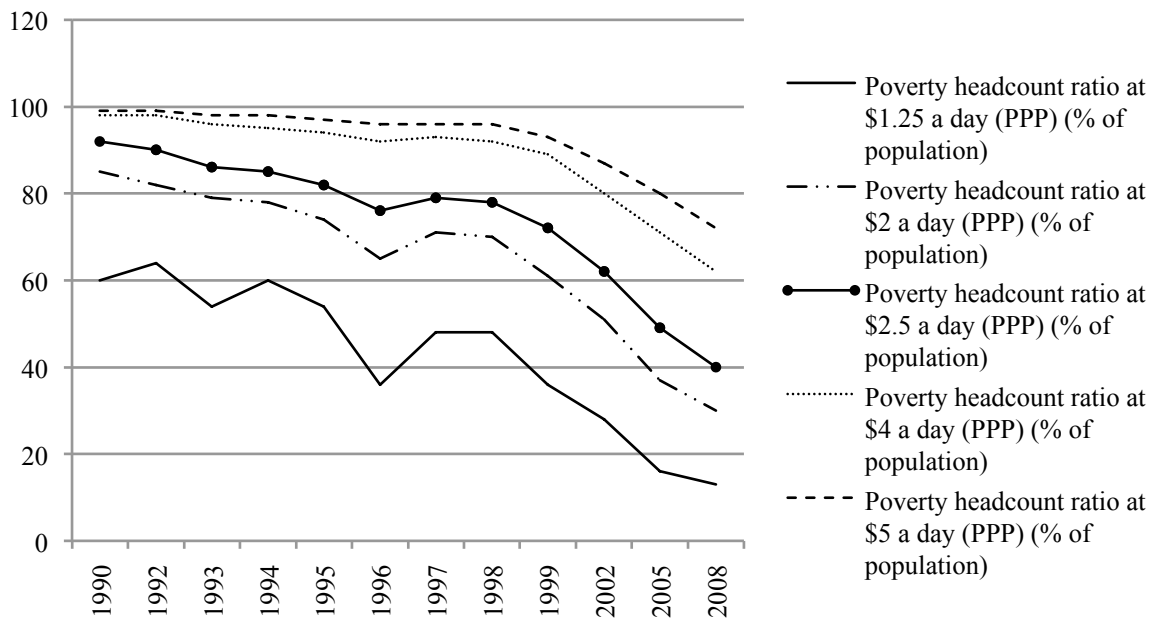
## 2. Institutional and Political Reforms

China’s transition from a closed economy to an open market economy is noteworthy in terms of the Chinese government not relying on a model of transformation. On the micro-level, collective farms were replaced by the Household Responsibility System (HRS) and the reform of the SOE’s, which included performance-based incentives for managers. On the macro-level this transition indicated a liberalization of the commodity pricing system and the implementation of a dual track price system, as well as the adjustment of the overvalued exchange rate and artificially low interest rates, even though, the interest rate level stayed below the market-clearing rate. This shows strong and continuous signs of China’s liberalization process within the political sector, which then led to a further liberalization of the economic sector. Reflecting on these developments, it can be generally argued that, change in China is a gradual and evolutionary reform process, which is characterized by a trial and error approach.

*“China’s policy model clearly resembles core features of the dominant paradigm for the development of East Asian Newly Industrialized Countries, building on a strong authoritarian national leadership and an elite state bureaucracy pursuing developmentally orientated policies, including the direct means of governing the market”* (Nee et al., 2007).

The Chinese economy managed to transform itself from a poor agrarian socialist state economy to a dynamic and capitalistic engine of global economic growth. This transformative economic growth led to a reduction of poverty, which has never been seen before to this extend. 630 million people moved out of poverty, which is accounting for 75 percent of the total poverty reduction in the developing world between 1990 and 2000 (Ravallion, 2008, 2007; Nee et al., 2007, 2012). The development of poverty reduction is further indicated by graph 1.

### Poverty Reduction in China



Graph 1: Poverty Development in China between 1990 and 2008 (World Bank Data Source, 2012, <http://povertydata.worldbank.org/poverty/country/CHN>)

Within this gradual reform process one can clearly observe the emerging role of the private sector economy, which in itself is perhaps the best indication for the level of economic reform. Assuming that the bigger the private sector is, the more pervasive the reform process will be and thus the closer the whole economic sector moves towards a market economy (Nee et al., 2012).

## 2.1 Grassroots Reform in China

After China’s collective movements in the 1950’s, the agricultural sector was organized as a collective system and was kept that way for roughly 20 years (Lin, 1988). The idea behind this collective system was to pay workers with so called “*work points*”. The main issue of this system concerned the size of the collective farms and identifying individual wages for specific jobs or functions. As collective farms included thousands of workers, the cost of supervising was extremely high. This led to an equal distribution of work points among all workers, which decreased their motivation to work hard. This resulted in an increasing inefficiency within the agricultural sector, which created a general food shortage. As a solution, the government started to lay the foundations of the Household Responsibility System (HRS) (Lin, 1988). Even though these reforms were never officially passed as laws, they were approved as State Council documents. Farmers who were now “freed” from the collective farms showed a rapid increase in income, which could now be reinvested, to additionally increase efficiency (Lin, 1988). While this strengthened the food supply it also freed up labor from the agricultural sector, which could now be employed in other economic sectors. Due to the large wage gap between rural and urban China, a large extent of migrant workers relocated to China’s coastal provinces (Zhou, 2012). Following the idea of “*leave the soil but not the land*” the rural migrant workers had low opportunity costs by leaving the countryside and trying to find more valuable employment. As family members would generally maintain the farms, migrant workers always had the opportunity of returning if no suitable employment was found. Overall, the adjustment of mentality by the general population as well as the government and the transcending steps taken towards collaboration laid the foundation for further important developments within the political and the economic sector. Reflecting on China’s history and considering the totalitarian regime of Mao Zedong up until 1978, it is possible to state that China has gradually shifted, even allowing registering private firms as of 1988, towards a more liberal system.

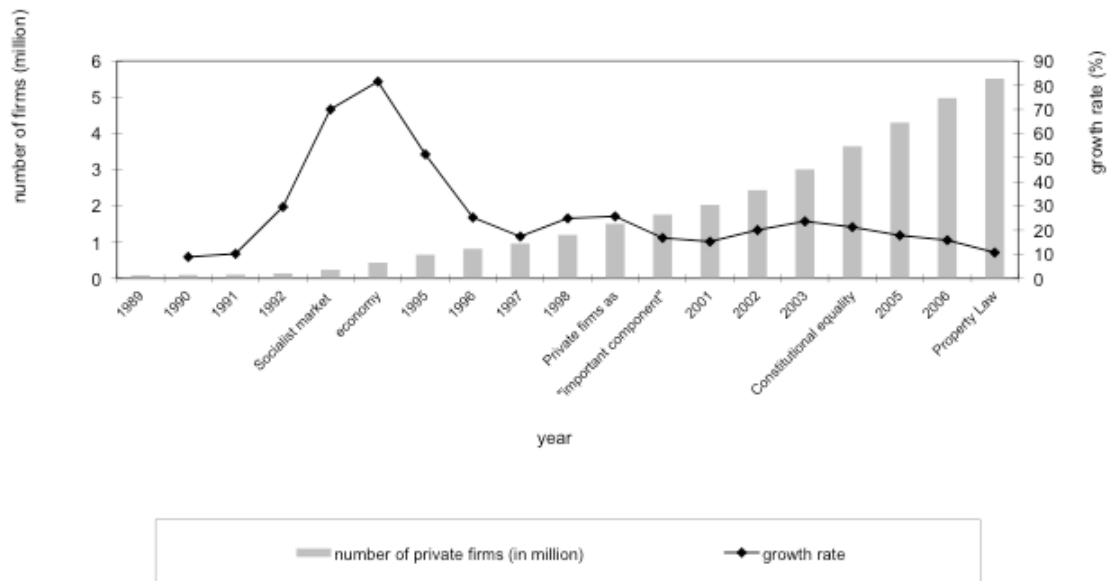
The enterprise reform was the result of two distinct approaches.

*“Chinese industrial productivity growth accelerated markedly in the reform period of the 1980’s. Before the reforms, industrial productivity had been almost stagnant. Total factor productivity grew at an annual rate of only 0.4 percent between 1957 and*

1978 (according to Chen, Hongchang, Wang, Zheng, Yuxin, Jefferson and Rawski (1988), but this changed after the reforms began. Between 1978 and 1985 industrial productivity grew at an annual rate of 4.8 percent (Chen et al.), and it continued to grow strongly after 1985” (Groves et al., 1994).

Despite allowing registering private firms, the private sector economy as a whole is not yet operating under the same conditions as State Owned Enterprises (SOE’s). The private sector economy was still stigmatized as being capitalist in the years after 1978 up until 1992 and only after Deng Xiaoping’s Southern Tour, the private sector started to obtain recognition as well as acceptance, leading to the rapid increase of the private sector as indicated in graph 2 and 3. In this form, the concept of the private sector was based on the indication, that the first entrepreneurs were the poor, uneducated rural citizens who had nothing to lose (Opper, 2011).

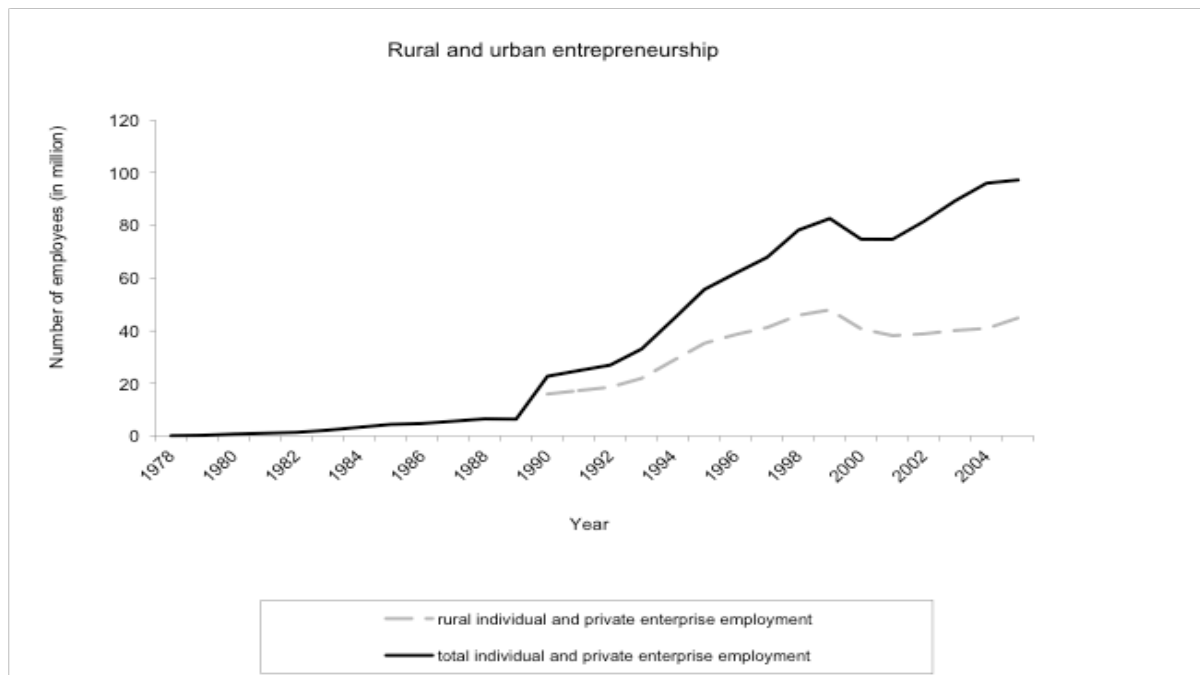
### The Development of China’s Private Sector



Graph 2: The emergence of China’s Private Sector, (Opper, 2011)



### The Development of Employment in China’s Private Sector



Graph 3: The development of rural and urban employment in China, showing the growth of China’s private sector (Opper, 2011)

The rise of China’s private sector economy can also be characterized as an anomaly, due to China’s general lack of many prerequisites needed for persistent economic growth. When evaluating the business environment in China the Global Competitiveness Report from 2002 – 2003 indicated that China being a transitioning economy, performed poorly in many conditions necessary for economic growth (de Soto, 2000). According to scholars such as Aslund (1995); Sachs (1993); and Sachs and Pistor (1997) China is lacking commitment to push for political and economic institutions needed of a market capitalist economy. The initial emergence of the private sector economy was very slow due to its lack of legitimacy, a weak legal status and the stigma of being capitalistic. Before the late 1990’s private firms were only referred to as a supplement to the economy, with this status now progressing to the private sector being an important driver of the economy. Despite all the prejudice towards the private sector, it was able to emerge as the most dynamic force pushing for economic development (Nee et al., 2007).

Another incentive for China’s policy makers to reform already established common practices and to introduce new systems such as the HRS was the change within the financial sector as well as the founding of China’s Stock exchange markets in Shanghai and Shenzhen.

*“The conversion of traditional SOE’s to joint-stock and limited liability corporations was the centerpiece of SOE restructuring and downsizing during the 1990’s”*  
(Naughton, 2007).

Implementing Company Law had a direct effect on the quality as well as the intensity of the government’s involvement on the firm level, while challenging its former monopoly rights for SOE’s (Nee et al., 2007). The development of the stock market showed signs of being promising especially for former SOE’s, which now could, due to partial privatization, sell a minority stake as a listed firm. By doing so, new shareholders were brought into the corporation, providing the company with new information, which could potentially lead to further privatization. The most important development for listed SOE’s included the new rules and laws concerning funding, which allowed a corporation to keep the majority share of the company (Naughton, 2007).

## 2.2 Central Government Reforms and Enterprise Reforms

Clarke et al. (2006) suggested, that the evolution of the Chinese legal system and its rule of law throughout the era of economic reform were vital for China’s development.

*“The role of law shifted over time, beginning as a tool to manage the state sector and then taking on the more recognizable function of providing the rules and processes that govern, however incompletely and imperfectly, the interactions of independent economic agents. This process of change has been gradual, coevolving with economic reforms, and it is very much still in process”* (Clarke et al. 2006).

The initial focus lay with improving the state sector and supporting or encouraging the private sector. Therefore, the legal system was seen as a mechanism, which monitors and regulates SOE’s and ultimately exchanges the old *“particularistic bargaining regime”* with one that would be strict and universal. By doing so managers of SOE’s would be responsible by law for mismanagement and could thus be punished (even with the death sentence), which encouraged managers to work more efficiently. One example of this includes the introduction of the Bankruptcy Law Act, which was passed in 1986. Prior to this it was possible for the government to cease operations of a failing or indebted enterprise, even though this was hardly ever done. Another indicator of the change of quality within the legal system was the increasing number of lawyers, as further indicated by Clarke et al. (2006), as a response to the increasing demand for legal services. In 1983, China only had roughly 8600 full-time lawyers (Chen, 2004), but in 2005 the number of full-time lawyer’s would increase and far exceeding the 100,000 mark (China School Net, 2005). As with almost all other reforms in the Chinese state sector, the change of administrative and legal methods of control has been very gradual. One example of this is Article 31 of the 1986 General Principles of Civil Law (GPCL), which states, *“that in order to have a partnership, a written agreement must have been signed”*. Despite this, only one year after the passing of the GPCL the Supreme People’s Court announced, that *“associations which have the characteristics of a partnership, even if there is no written agreement, should be treated as if they were in a partnership”* (Supreme People’s Court, 1988; Clarke et al., 2006).

Despite all these developments in the economic and in the legal system the main motivation for developments came from domestic developments. Even though this is the case, since the beginning of China’s opening the Chinese government recognized that in order to attract foreign investors who would be willing to establish a business relationship, the legal system would need to develop and become more compelling to foreigners. This led to a unification of the different legal regimes, with the intent of assembling the system in a matter, which is more recognizable to foreign investors. One example of the regime leading the way to transformation in substantive law is the so-called 1979 Equity Joint Venture law. It states that, joint ventures would not be nationalized or expropriated, and if for some reason this would happen, that an “*appropriate compensation would be paid*” (Clark et al., 2006).

*“Although the legal system has made great strides since the beginning of reforms and currently has a role of some significance in the economy, it is impossible to make the case that formal legal institutions have contributed in an important way to China’s remarkable economic success. If anything, economic success has fostered the development of law, rather than the reverse”* (Clark et al., 2006).

Drawing a conclusion from these developments it seems that the formal legal system only played a minor role in fostering developments, even though the court system as such has gained a more significant role in the settlement of disputes. One indicator of this is the increasing demand for lawyers as well as an increase of cases brought to court. One critical change, which could improve the rural economy and additionally decrease the gap between the rural and urban population, would be with regard to property rights. If more robust property rights were to be installed, these could potentially prevent social and political disputes, especially regarding farmers, which have to leave “*their land*”. Instances like this occur more often than noticed, and frequently include the government using the land for redevelopment projects, without paying the farmers a satisfactory amount of compensation. Additionally, these laws could allow a better distribution of land, which could then be farmed to its highest potential and further increase agricultural efficiency. Thus the issue of the lack of adequate property rights can be used as an example, in which the absence of a functioning legal system can be very costly for further economic developments, and could potentially even increase costs (Clark et al., 2006). Nevertheless, the current status quo of China’s legal system shows significant improvements, which is indicated by the Contract Law and

Company Law Act passed in 1993, the enactment of the Security Law Act in 1998 as well as an increase in Property Rights in 2007, even though these are still dependent to the state interest. Furthermore, the constitutional commitments of only “*lawful property*”, in which “*lawful*” is a privilege of the state undermines the idea of robust property rights. Also, individual rights, which include property rights, cannot be in conflict with interests from the state and it is decided by the state to what extent property rights are enforced and recognized. Despite the increasing cost to China’s economy of not having an independent legal system, change seems to be unlikely in the near future. However, the inflated growth rates irrespective of insufficient legal provisions should be taken into account. Nee et al. (2007) characterize China as a hybrid state, in the midst of transition of economic reform and political stagnation, which is described as “*politicalised capitalism*”.

*“After all, the same state that managed production and distribution under central planning guides the transition to capitalism. [...] A deepening market transition is under way, partly enforced by commitments to liberalization specified in China’s WTO accession. [...] Even in the banking sector, currently the most regulated sector, the trend is clearly in the direction of liberalization”* (Nee et al., 2007).

The transition process is described by the fiscal decentralization and the fast expansion of the private sector economy. At the same time, the local government is becoming less involved in economic decision-making on the firm level and is instead focused on attracting more business investment to the local regions. Despite these developments, China still lacks true political reforms, such as free electoral votes, which would be necessary for China to emerge as a “*mature*” state as defined by Western society. A nation possessing an independent legal system, the right to free elections as well as other constitutional human rights including free speech or “*the right to own property alone as well as in association with others*” (UN Charter of Human Rights, Article 17) would be deemed a “*mature*” state by Western standards (Nee et al., 2007).

## 2.3 The Start of Democratic Development in China?

An extensive amount of literature has been published concerning the relationship between democracy and development, but few scholars have actually provided a definition. Overall, the academic world is divided around the discussion of the true meaning of democracy and its implications. From Aristotle to Marx, debates around the interpretation vary from an emphasis “*on equality of participation in decision-making of all citizens, to the more complex indices emphasizing competitiveness and civil liberties*” (Midlarsky, 1997). According to Samuel P. Huntington, the world has never been as democratic as it is today. In his research he describes global political developments over the last century and finds an increase of democratic states from 27 percent in 1974 to 61 percent in the late 1990’s (Diamond, L., 1999, a). This period of democratic growth peaked in the early 1990’s with a further increase of democratic nations from 76 to 117 (Diamond, L., 1999, b). China being a totalitarian regime is one of the only non-democratic nations leading the world economy<sup>6</sup>.

Throughout the history of the world, foundations of democracy have been laid through revolution, war, or political shock. Western Germany can be seen as one of the only nations, where a democratic system was not a gradual or evolutionary process but rather a political shock pushed upon the nation by the United States of America after the Second World War (Diamond et al., 2000, p.2). The United States of America, also one of the oldest democracies of the world, is often described as a government by the people, for the people. This phrase shows the true underlying meaning of democracy, which has caused worldwide uproars. The power of the people can be seen through the abolishment of the French authoritarian system by the Great Revolution of 1789 or even today’s “Arab Spring”.

The discussion of democracy plays a vital role in China’s reform process and its future development, as democratic ideals are starting to manifest itself within the Chinese population. Diamond et al. (2000, p.2) describes democracy as,

*“a civilian, constitutional system in which the legislative and chief executive officers are filled through regular, competitive, multiparty elections with universal suffrage”.*

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<sup>6</sup> List of countries by GDP (nominal): (1) the United States of America, (2) China, (3) Japan, (4) Germany, (5) France, (6) the United Kingdom, (7) Brazil, (8) Italy, (9) India, (10) Canada (United Nations, 2010).

This form of democratic development can be found on the township level in China. Elizabeth J. Perry and Merle Goldman analyzed China’s democratic evolution in their book “*Grassroots Political Reform in Contemporary China*” (2007). The sustainability of these first indications of a democratic movement within the country is depending on a large number of variables, which include the level of freedom granted to the notion of democracy in social as well as economic terms. For example, the lower the barriers to entry, the higher the likelihood of a developing democratic system. The same applies to other democratic foundations, which include the freedom of movement, freedom of speech (at least to a certain point for it to be categorized as democratic), the level of corruption within the system (as noticed by a number of scholars such as Williamson or North, corruption is a sign of weak institutions), the willingness to change (the level of acceptance and how high is the willingness to progress and develop the political status quo within the society), as well as a consideration of the current status of development in terms of HDI. Having said that, it becomes clear that the level of “*true democracy*” can vary, as a country can qualify as democratic, while at the same time violating the most basic human rights, which include the equal treatment of all people and the abidance of the rule of law.

The ultimate and true level of democracy is only reached if elections are fair, and human rights are respected. Elections are considered to be fair, if:

*“they are administered by a neutral authority not controlled by the ruling party; when that neutral authority is also sufficiently organized, resourceful and competent to take various precautions to prevent fraud in the voting and vote counting; when the police, the military and the courts treat competing candidates and parties impartially during the campaign, the vote counting and the resolution of any post-election disputes; when competing parties and candidates all have access to publicly controlled (or state-influenced) mass media; when electoral districts and rules do not put opposition parties at a systematic disadvantage; when party and independent monitors may monitor the voting and vote-counting at all locations; when the secrecy of the ballot is protected; when the procedures for organizing and counting the votes are transparent and known to all; and when there are transparent and impartial procedures for resolving election complaints and disputes”* (Elklit et al., 1997).

Today roughly 30 countries are holding competitive, free, and fair elections even though in some cases citizens are considered to be less free than in a true liberal democracy (Diamond et al., 2001). Comparing the United States and Russia for instance, it is possible to state, that even though both countries hold general elections, the citizens of the United States are considered to possess more freedom and full access to human rights, as laid down by the constitutional Amendments. Additionally, an inefficient judicial system, the interference of the military (as being observed for example in Egypt) along with other issues can be the ground on which a country can be referred to as a non-liberal electoral democracy (Diamond et al., 2001). The question of democratic standing of a nation is more complex than the statement that “*yes this nation is a democracy*” or that it is not. Democracy as such must be understood in a broader perspective and thus a situation can arise, where the different classifications within a country (national, provincial, local, regional, city or village level) can have different political values. This is the case in China. On the national level China is less democratic than on the village level. This can be observed when looking at township village elections in Mainland China in a direct comparison to Hong Kong. Hong Kong is a special case from any perspective; it is even being characterized as a “pseudo-democracy” (Diamond et al., 2001, p.4). The term “pseudo-democracy” is accurate, because Mainland China enforces tight political rules for the electoral process, through the strict control of the legislative branch, to channel greater political power to the chief executive branch to preserve its authority. Even though Hong Kong has a much higher measure of individual freedom than Mainland China and possesses a functioning legal system, the political oppositions are weak and would never have the opportunity to form an independent government. Even though Diamond et al. (2001) describe China as being an “*authoritarian regime, which rules out formal political opposition of any kind*”, this paper argues that the level of governance within China is the deciding factor determining the future success or failure of political and economic developments. Thus it is possible to state that, even though China is governed by an authoritarian regime, a gradual process of liberalization and movement towards democratic ideals has come into existence. These developments are mostly found on the lowest governmental level. The townships and villages are starting to create a broader base of acceptance within society. Thereby, the democratic domino theory can be applied to a certain degree, which generally states that an “*increase or decrease in democracy in one country can spread and ‘infect’ neighboring countries, increasing or decreasing their democracy in turn*”



(Leeson et al., 2009). Thus, applying this theory to China in a hypothetical sense, the recent developments towards a more democratic mentality within some provinces could potentially spread throughout the entire country. Even if this would not be the case, it is still possible to say, that there is a certain paradox within China, as parts of the authoritarian regime are showing the beginnings of democratic ideals, especially within institutions and village elections, and therefore a tendency towards a more liberal and electoral democracy.

The only Chinese democracy in the world is Taiwan (Diamond et al., 2001, p.7). It is much more likely for a country to develop into a democracy after a period of political suppression out of which elections and political leaders develop (Scalapino, 1998).

*“From this perspective, it may be regarded as significant that the PRC has been shifting from an ‘uninhibited political centre with transformative policies towards an inhibited centre with accommodative policies’, or in other words, from a totalitarian to a more conventional authoritarian (if not authoritarian-pluralist) system”* (Metzger, 1998).

The development towards becoming a democratic nation needs to be reflected throughout all layers of society. This includes all citizens, from the political elite all the way through to the middle and working classes. Scholars such as Lipset (1994) and Diamond et al. (2001) point out that the “*social requisites*” must be fulfilled in order for a country to become democratic. The society itself must have adapted to the idea of a democratic system, therefore building a base on which further political and social developments can take place. In order for society to carry political developments and guarantee further improvements towards democracy, it is necessary that society experiences the positive effects, which could for example include a reduction of poverty or unemployment rates. If society becomes part of the positive development, a broader acceptance and change in mentality can lead to a stronger foundation for the liberalization of the political and economic systems.

### **An analysis of the Chinese Model and the importance of institutional change for China’s developing economy**

The literature on traditional development economics, which originates from neoclassical economic growth theory, generally finds a negative relation between the role of the government and economic growth (Song, 2012, p. 27). Therefore, development economics is

increasingly being criticized for not having its own system and thus being discriminated. However, within academia and especially by the second generation of development economists, the crucial role of the governments is often being emphasized (Grivoyannis et al., 2012). This is in particular the case for the Chinese and also the East Asian model. The capacity of East Asia to swiftly catch up with other developed nations and the triumphing role of new institution economics has altered the academic position on the role of the government. Thus Song (2012, p.29) states,

*“that appropriate institutions, historical experience, the context of social capital, and the relation between state and market in the process of development should be the key variables in the model of development economics”.*

Song (2012) suggests a new model of economic development, which not only focuses on technological progress, the role of labor, capital and entrepreneurial contributions, but additionally the importance of the institutional change of state, thus highlighting the significant role the government plays in economic development.

One reason why mainstream economic literature has failed to explain the process of development economics is because it is based on the abstract neoclassical ideas of a market in which price is determined by demand and supply. On the one hand, it is believed that the number of buyers and sellers is large enough, that an individual has no influence on price levels and market forms such as monopolies, which are mainly ignored. This is further supported through the belief, that the goods sold are similar. On the other hand it is also believed that sellers are setting prices depending on their market share, so it is influenced exogenously. Consequently, the selling price in a market with perfect competition is just slightly above the cost of production, thus high enough to create a profit that is justifying the whole production process. The failure of this model lies with being abstract and simplified, to the extent that it does not include the impact of changing institutions on the economy or considers the significance of entrepreneurs, who are key decision-makers within a market economy. The actual price of a product is not the pure outcome of a supply and demand function like many economic models suggest, but rather the ability of agents within the market to price bargain (Song, 2012, p.30 ff).

*“The negotiations of sellers and buyers after the first bidding, based upon the bidding price and the information provided by an economic entity (Stiglitz, 2004), is the typical process of a business. In the real market though, the price is the result of bargaining and decisions, and not exogenous information before the decision. Similarly, Knight stressed very early (1921) that the function of entrepreneurs is irreplaceable; it is the entrepreneur who makes the market economy an economic system, but which is overlooked by information economists, who focus their attentions on the imperfect information” (Song, 2012, p. 31).*

Thus, one could argue that China’s rapid economic growth, especially since 1992 was only possible due to economic, social and cultural transformations within China, supported by events such as Deng Xiaoping’s Southern Tour.

Nevertheless, the private sector developed into the main driver of economic growth, in regard to employment numbers and economic output (Nee et al., 2012).<sup>7</sup> As Song (2012) correctly points out, the catching-up process of the Chinese and other East Asian countries depended on using and implementing the structure of Western economic markets and institutions, thereby creating the foundations for a market economy. Even though there is no consultation between the government and economic entities within the Chinese economy.

The question remains of how much of China’s economic growth – despite political restrictions – can be traced back to the already high levels of human capital prior to 1978. Key variables for a further evaluation would have to include a consideration of social capital, the connection between state and market and how this is affecting the process of development (Song, 2012, p.29). A central universal issue within the process of transition and development of an economy is the role of institutions with regard to the safeguarding of property rights, which create the very foundation for a motivation to change the economic status quo. Without clearly defined property rights, the risk of expropriation would strangle the first developments and thus any further significant economic development would become very unlikely. Without this clear definition, entrepreneurs would not be capable of engaging in market activities, due to the risk of expropriation, the stopping of any kind of development, innovation, and trade

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<sup>7</sup> “The private sector, even though it is accounting for about 60% of the Chinese GDP, creates 85% of all urban jobs and 90% of all the work done by migrant workers is still being heavily discriminated” (Caixin, 2010).

and therefore leaving the economy with an outlook of decline (Meier, 2001a; Rosenberg et al., 1986).

With regard to the above theoretical debate concerning the role of institutions and the state within economic development and market fluctuations, it is important to highlight yet again that especially within any analysis of Chinese growth, consideration needs to be given to all key drivers of economic development. Thus, in order to understand the process of economic development it is not enough to look at the neoclassical models, as the institutional change of governments must be included as well. As mentioned by Bardhan (1998, 2001) the model of economic growth, which is based on the function of production, fails to explain development economics, as it is concentrating on the transformation of only the economic system, without consideration given to historical, cultural or social developments. When considering economic development and the rise of a successful market economy it can be observed that the result, the institutional change of state (Song, 2012, pp. 30-33), describes the Chinese situation over the past three decades. Scholars such as North and Song have been stressing the point that a key for economic development is the role of the state. The efficiency of property rights is determined by the state and therefore it is the state that is affecting economic growth, stagnation or a depression and thus the key element of Chinese growth and transformation.

### 3. The Link Between Political, Civil, and Economic Liberty and Economic Growth in China

Scully (1988) provided the first cross-country analysis supporting the crucial impact of the institutional framework as measured by political, civil and economic liberty on economic development. In his analysis of 15 market economies over the period 1960-1980, his estimates indicated that politically open societies, which respect the rule of law and private property rights, grow at three times the rate as societies where these rights are restricted.

Keefer and Knack (1997, p.590) study the rule of law, pervasiveness of corruption and risk of expropriation and contract repudiation as typical institutional outputs of insecure property rights. Their study also incorporates various political and constitutional variables. The estimates suggest that per capita growth between 1960-1989 was actually significantly and negatively affected by weak property rights, which were the result of weak institutions.

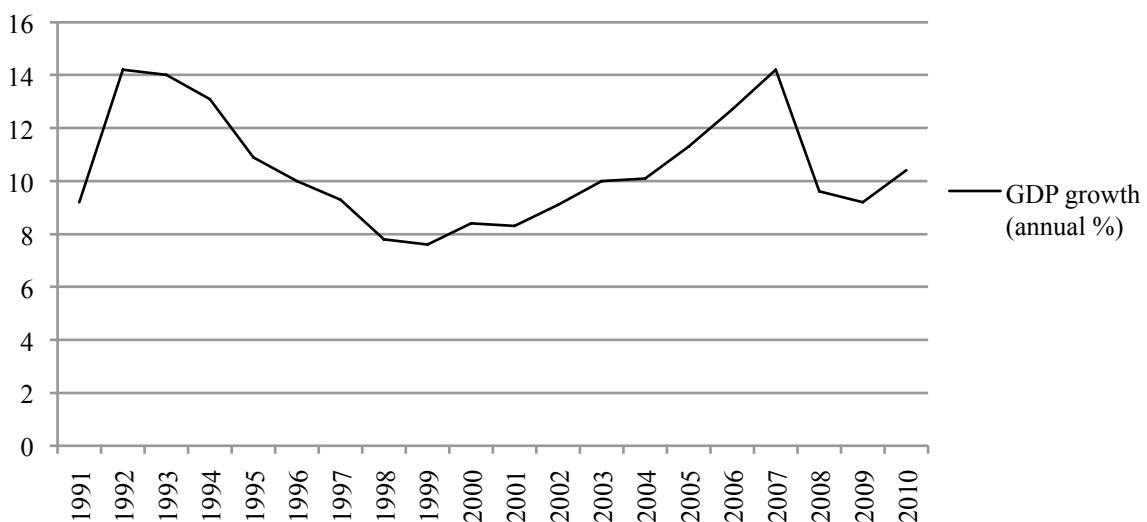
Henisz (2000) applies an even stronger focus on the role of politics and developed an index to measure political institutions. He provides evidence that political institutions had a significant positive influence on national growth rates in 157 countries in the period between 1964 and 1994.

The first empirical evidence for transition economies confirms that institutions actually play a significant role in explaining economic growth during transition periods (Havrylyshyn et al., 2003).

Previous research, such as Lee, Han and Lin has focused on Asia and in particularly China’s development in considering the so-called East Asian Model (EAM) to explain the rise and development of Asia. When we look at Asia, we will find a region that has shown constant elevated economic growth in the order of 8-9 percent per year over a period of 60 years, as indicated in graph 4, which as such has never been seen before. Having initiated this development, Japan built the foundation on which different phases of growth and development in Asia were possible. As a whole, East Asia’s evolution is also referred to as the “*East Asian Model*” or the “*East Asian Miracle*”. The EAM is used to show how the region has developed by examining authoritarian regimes, which have transformed such nations as South Korea, Taiwan, Hong Kong and Singapore. The problem of this model is

that for each country that succeeded in becoming wealthier, increasing economic growth and at the same time increasing its Human Development Index (HDI) there is a counter country that was not, or only partially able to improve its situation. There are South Korea and North Korea, the rise of Taiwan and China under Mao Zedong, Singapore on the one hand, and the Philippines on the other hand to only name a few. This is leaving the EAM with the problem of a selection bias (deep end selection bias) by only including the winners (South Korea, Taiwan, Singapore). In fact there is no statistical support that could be used to build a case against the argument that the authoritarian regimes have an advantage over democracies in terms of economic growth (Yasheng Huang, 2011).

**China's Economic growth measured in GDP**



Graph 4: China’s economic growth measured in GDP growth (annual %), (World Bank, 2012, Data Set)

Barro has contributed to the discussion of democratic developments affecting economic growth in 1999 in his article called “*Determinants of Democracy*”, which can be transferred to China, because it partially describes China’s economic rise initiated by reforms within the political system. He came to the conclusion that there is a positive relation between democracy and economic growth.

North (1990, p. 3) concluded that:

*“Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic.”*

*Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change”.*

Since China’s economic reforms in 1978 constant market transition has taken place, which leaves China with a longer period of thriving towards a market economy than the socialist period under Mao Zedong. This transition could be characterized in waves of economic reforms where the subjects of the reforms itself were adapted to the economic challenges at hand. The way of transition, despite major setbacks such as the Tiananmen Massacre, was undoubtedly towards a market economy, where China today has reached a tipping point within economic developments (Nee et al., 2012). This can be seen when looking at the increase in property rights or the increasing size of the private sector. China’s development towards a market economy is not completed as indicated by Naughton (2007, p. 85) but the developments are on the right track.

The starting point for China’s transition, “socialism with Chinese characteristics” can be linked back to rural China, because it was here that the first reforms were initiated which carried the successful reform process and therefore allowed the government to focus on the basic subject of transition. Starting in 1978 two phases of development can be found.

*“The first phase of gradual, dual-track<sup>8</sup>, decentralizing reforms developed directly out of the rural successes. The basic purpose of this phase was to begin the dismantling of the command economy while maintaining economic growth, an objective that was substantially achieved. Markets were introduced into nearly every area, ownership was diversified, and competition created, all within the framework of the existing institutions. During the second phase, after about 1993, the emphasis of reform shifted as it became more fundamental and thorough. The main accomplishments of this phase have been the remaking of the institutional setup to make it compatible with a market economy, the dramatic shrinking of the state sector, and the creation of conditions enabling fair competition among all market participants. The second stage is still ongoing” (Naughton, 2007, ch.4).*

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<sup>8</sup> The dual-track system, or the Chinese term “*shuangguizhi* refers to the coexistence of a traditional plan and market channel for the allocation of a given good. Rather than dismantling the plan, reformers acquiesced to a continuing role for the plan in order to ensure stability and guarantee the attainment of some key government priorities. The dual track implied a two-tier pricing system for most goods: a single commodity had both a (typically low) state-set planned price and a (typically higher) market price” (Naughton, 2007, p.92).

Noteworthy, throughout this whole development process was that this transition could be characterized as a bottom-up gradual and evolutionary procedure. There was no such thing as a blueprint and the idea of developing China towards a market economy had to be carried out by a trial and error approach, which took time. China’s gradual and evolutionary reform process enhanced the transition, which fostered economic growth at the same time as it allowed institutions to develop and adapt to the changes. Unlike the former soviet countries, which wanted to leave the communist era behind them and start over, Chinese reformers were confronted with unmet demands for just about everything due to the misallocations, which had resulted in a waste of resources, which were mainly directed to expensive projects, especially within the heavy industry sector. This had left China as a poor and underdeveloped country. It became clear that the Chinese economy and the Chinese people could only improve their standards if the incentive structure to work would change. The idea was to allow individuals and organizations to fill the gap and satisfy the unmet demands, which as a result would generate additional income. In order for this to happen it was necessary that barriers to entry within the economy would have to be lowered and hence the tightly controlled system would have to open up allowing for a private sector economy to develop. Even if the private sector economy was stigmatized as being capitalistic and therefore discriminated, it developed and broke with the old system. Despite the stigma attached to private firms those entrepreneurs were efficient and much more flexible to act on demands within the market than the SOE’s with their huge bureaucratic structure. These developments laid the foundation for township village enterprises (TVE’s) because they were now seen as complementing economic growth and development in rural China and therefore attract further local investment, which led to even more economic growth.

The next step was to allow foreign companies in SEZ’s with the idea to create favorable economic conditions, which would attract foreign technology and help China, move up the ladder. The SEZ’s were seen as an experiment because they would allow foreign investment and the transfer of technology at the same time, as they would entitle the government to stay in control and take the next step. The result was that regulations for the SEZ’s were reduced with the intention of allowing positive spillover effects into the Chinese economy. This in turn created increasing competition and developed into a situation, which initiated a shift from a planned economy towards a market economy. These developments, leading to a new situation within the economy also required new economic reforms, which began in the mid-



1990’s and resulted in the dual-track pricing system plan, leaving prices to become unified and abandoning the state set pricing system. The dual-track pricing system, allowed the economy to adapt to the changing environment and hence allowed a smooth transition, both socially as well as economically (Grivoyannis, 2012; Naughton, 2007, ch.4).

*“And since growth is the only source of legitimacy for the ruling party, the economy would not be the only thing to wobble. From 1990 to 2008 China's workforce swelled by about 145m people, many of them making the long journey from its rural backwaters to its coastal workshops. Over the same period the productivity of the workforce increased by over 9% a year, according to the Asian Productivity Organization (APO). Output that used to take 100 people in 1990 required fewer than 20 in 2008. All this meant that growth of 8-10% a year was not a luxury but a necessity”* (The Economist, 2012 b).

One of China’s biggest challenges seemed to be the constant shortage of food which had a direct negative impact on economic developments and it was not until this problem had been solved that China could fully push for further economic reforms. When looking for the motivation and the roots for allowing a shift within the system one must look at China’s agriculture sector. After decades of struggle and constant food shortage the government decided that it would have to release the pressure on farmers and give *“farmers a chance to catch their breath”* (Naughton, 2007, ch.4). In order to go through with this decision, additional sacrifices needed to be made; at this time it was the secondary sector that would have to indirectly help the primary one. Investments, which were initially for the accumulation of technology, were redirected towards the primary sector, leading to a stabilization of procurement targets, an increase of the price level and a drastic increase of prices intended for farm deliveries, which were above the actual target rate (Naughton, 2007, ch.4). All these developments can be related back to the idea of Federalism Chinese Style, indicated in chapter 1 of this thesis.

In a wave of reforms the government decided to give collectives the right to try new ways to increase output. One very new and also controversial idea of the time was to distribute parts of the land to farm households, which took over and started cultivating the land for agricultural production. The motivation for these farm households, included that everything

exceeding the set production levels of produced goods, with low prices and low tax rates, could be kept and sold at market prices, thus increasing income (Naughton, 2007, ch.4).

This drastically changed China’s food supply and it seemed that for the first time in decades everyone had enough to eat and that one now could focus on further economic developments. As the excess labor, which had been locked into the collective inefficient system, was now being released and farming itself became much more efficient more and more people in the countryside had time to participate in the economy; the number of TVE’s increased rapidly leading to an additional increase of output. On the one hand, TVE’s created a form of competition for SOE’s, and on the other hand they were able to move into niches and stimulate unmet demands within the market, which SOE’s could not due to their size. In addition, SOE’s were dependent on their larger bureaucratic system, which left them slower to adapt to changing market conditions. These developments rapidly increased the standard of living for the rural population and gave an additional momentum to the overall developing reform process carried out and supported by the rural population. The overall reform process from the beginning of China’s open door policy until the early 1990’s can be characterized as decentralizing power and recourses from the central to the local governments, the creation of a dual-track system, incremental managerial reforms as an alternative to privatization, and disarticulation. This meant that successful parts within the economy were separated from the planned economy. The reduction of state control and the increasing acceptance of new market players created a situation in which new firms increased competition, thus creating a new market environment to which also the state sectors needed to adapt. This increase in competition also meant that the state sector was forced to increase its efficiency to stay competitive. These developments lead to an increase in economic performance, with different growth rates, as the state sector was not able to experience the same growth as non-state firms (Montinola et al., 1995).

Due to the fast economic developments across most economic sectors, the economy itself grew to a greater extent than previously planned, mainly because of a shift within the economy, which allowed new players to gain market shares from SOE’s. It became increasingly challenging to plan economic development due to the accelerated growth, especially since the state was no longer the only player. China’s economy developed faster and in a more complex way than anyone had expected, thus leaving policymakers a step

behind. The fundamental reforms, which would have the biggest and most significant impact on China’s further developments, were the recentralization of financial resources as well as the redistribution of macro-economic decision-making from the central to the local governments. After having established the new reforms policymakers could now shift their focus on other significant economic sectors. They concentrated on the financial sector, especially the tax system, as well as China’s admission to the WTO. These actions reduced the inflation levels and created price stability; while at the same time reducing the total market share of the SOE’s and with that increased the acceptance of the private sector (Naughton, 2007, p.100).

Deng Xiaoping’s Southern Tour triggered euphoria within China’s economy. It signaled to the Chinese economy and the people, that the political elite was pushing for economic liberalization. It also indicated the acceptance of the new market players including the private sector economy. This euphoria led to a rapid increase in bank credits, which increased inflation, which by 1993 on the country’s economic brink led Zhu Rongji to initiate a macroeconomic austerity (Grivoyannis, 2012).

*“A financial crackdown was clearly necessary, but it turned out that this crackdown signaled the beginning of a new macroeconomic policy regime, which delivered much less cheap credit to state-owned enterprises and a slower growth of money and prices. By 1997 at the latest, it was clear that Chinese policy had shifted to a long-term policy of macroeconomic conservatism and had managed to deliver a significant degree of macroeconomic stability. This shift was an essential prerequisite to making public enterprises responsible for their own profits and losses, providing them with a hard budget constraint”* (Naughton, 2007, p. 102).

China’s reform process could be spelled out as *“the theory of induced institutional innovation”*. Clarke et al. (2006) described this development, which occurred in different stages from 1978 – 1984. The first stage, included:

- 1981- *“The state council established provisions governing private investment in the form of individual firms (also referred to as getihu) in cities and towns, limiting the number of employees to seven.”*

- 1982 – Basis of China’s economic system was socialist public ownership, indicating that the state sector was the leading economic sector. The private sector was seen as a complement to the socialist public economy and no contract law was in fact covering the private sector up until 1986.

The second stage, as referred to by Clarke et al (2006), lasted from 1985 to 1989, which is characterized by the actions of the Congress of the CCP in 1987 recognizing more generally the private sector as a necessary supplement to the state sector.

The third stage (1989-1992) can be seen as taking a step back in the reform process. Not only did the Tiananmen Massacre have a negative impact on economic developments, but also additional recentralization and a strengthening central planning seemed to take away some of the newly acquired sovereignty gained by the provinces.

The starting point of the fourth stage of reforms can be related back to Deng Xiaoping’s Southern Tour from 1992. Throughout this tour, he campaigned for a greater acceptance of the market, up to the point, where the CCP endorsed the “*socialist market economy with Chinese characters*”.

## 4. Political and Economic Implications of China’s Accession to the World Trade Organization

China became a member of the World Trade Organization (WTO) in 2001 after having been a candidate for 15 years. One could argue that by becoming a member of the WTO China has managed to truly re-integrate itself into the world economy, which signifies a major success for China’s reform process. Scholars such as Bhattasali et al. (2004, p.1) argue that China’s policymakers were so eager to become part of the WTO, due to it improving economic conditions and using it as a channel to resolve trade tensions, which could rise due to the country’s political organization or its recent economic developments. Overall, the admission came at a crucial time in the reform process, as it pushed further reforms for a true market economy as well as institutional amendments.

Since being admitted to the WTO’s through the Doha ministerial meeting in November 2001, China can be characterized as a very active member and one of the main drivers of world trade (Panitchpakdi et al., 2002). Bhattasali et al. (2004), state that China’s admission was a crucial development, as it includes China agreeing to be governed by the rules and regulations presiding over the members of the WTO, as well as the fulfillment of the basic principles for accession, which include the following:

- Non-discrimination
- Market opening
- Transparency and predictability
- Undistorted trade
- Preferential treatment for developing countries

The guidelines for non-discrimination point to the behavior towards competing suppliers (the most-favored-nation principal), while non-discrimination refers to the conduct towards domestic and foreign produced imported goods and services within China. This includes the elimination of the dual pricing system, restrictions on trade and investment, as well as the implementation of a “more uniform administrative arrangement and judicial reviews”, which effect all levels of government.

The market opening principal includes three important elements:

1. *“Commitment by China to abolish nontariff barriers, reduce tariffs and open up the service sector,*
2. *Commitments by the importing countries to abolish the quotas on textiles and clothing originally imposed under the Multi Fiber Arrangement (MFA),*
3. *Agreement by the United States of America and other countries to impose MFA tariffs on China”.*

(Bhattasali et al., 2004, p.2)

However, the guidelines for transparency and predictability of trade policies are aiming towards achieving these goals through the support of trade rules and regulations, which need to be *“committed to push out restrictions on trading rights for all products except a short list of commodities”* (Bhattasali et al., 2004, p.3).

The WTO principles for accession applying to undistorted trade generally impact subsidies, counter value measures, anti-dumping rules as well as safeguards regulations. Of these criteria, anti-dumping and safeguards regulations constituted complications for China during the admission process to the WTO. It should be acknowledged, that preferential treatment of developing countries, including China forms a prominent debate within the WTO. The specific issues concerning China’s admission led other WTO members to consider China as a fully developed country in terms of its economic size. The importance of China being recognized as a developing country lay with developing countries being given a special status within the WTO. This would allow China special arrangements in areas such as the phasing out of quotas and licenses. Since China’s admission to the WTO it has increased intellectual property rights, patents and trade secrets (Bhattasali et al., 2004). As previously mentioned, becoming a WTO member takes a long time due to the long process of passing reforms and laws regarding trade issues (WTO, 2002). For China, some of these reforms actually exceed the required WTO accession agreement. An example of this includes the recognition by the Chinese government of the large income gap between rural and urban China as indicated by Wen (2004).

A number of scholars came to different conclusions regarding the level of protectionism within China’s agricultural sector. Huang et al. (1999) came to the verdict that China’s

agricultural sector in the mid 1990’s was protected between 4.2 and 25 percent, depending on its protectionism. Whereas scholars such as Tuan and Cheng (1999) calculated, that the protection of China’s agricultural sector for the same time period ranged somewhere between 29, 62 and 15 percent. Other scholars such as Carter (2000) and Martin (2001) estimated that China’s WTO admission had only a minimal effect on the level of liberalization within the agricultural sector and thus opposed previous statements made by Schmidhuber (2001). Considering the large variety in expert conclusions presented by different groups of scholars ranging from a variety of fields, based on the same information, the complexity of the impact of China’s WTO admission becomes visible.

At the same time, China’s tariffs on a variety of industrial products have been reduced from 46.5 percent in 1992 to 6.9 percent since the accession. However, it is necessary to state that China had already reduced tariffs of 33 percent of the weighted average since 1992 prior to the WTO membership (Martin, 2001). For example, tariffs on beverages and tobacco were reduced by 28 percent, whereas automobiles saw a decrease of 15 percent, other industries including textiles, electronics and light manufacturing were also affected (Bhattasali et al., 2004, p. 8). It must be recognized that China has made more commitments within the service sector than any other member of the WTO, by focusing on market access and breaking down trade barriers as indicated by scholars such as Luo et al (2004), Bhattasali et al. (2004) and DeWaskin (2001). Overall, the accession to the WTO displays a positive impact on China’s economy, which include increasing investments in “*more capital – and skill – intensive goods in response to high rates of investment and rapid growth in education levels*” (Ianchovichia et al., 2001).

China’s positive developments within the WTO could potentially have an even greater impact on the Chinese society, if restrictions within the Chinese system such as the so called “*hukou system*”<sup>9</sup> would be abolished. The hukou system restricts the movement and migration patterns of the rural population within the Chinese territory. The complete mobility of labor is a crucial necessity of any further reform. As previously mentioned, other barriers to reform include property rights, which limit investment due to insufficient motivational incentives, as

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<sup>9</sup> The Chinese government introduced the “Hukou System”, which is a family registration system, to control the movement of labor between urban and rural China. People are categorized as rural or urban and in order to seek employment in a different province or region one must receive a permit to do so.

the government is still the true owner of landholdings. Therefore the urban population profits to a greater extent from reforms, especially in the short-term in direct comparison to the rural population. However, in the long-term the rural and the urban population should profit from general reforms due to spillover effects (Bhattasali et al., 2004, p.16).

*“Abolition of the hukou system and reform of the labor market more generally would raise farm wages and allow 28 million people to migrate to non-farm jobs in search of a better life. It would lead to an even bigger expansion of the labor-intensive manufacturing sector. An increase in education spending, to improve skills, would have a positive impact on the structure of the Chinese economy. The real wages of skilled workers would fall, while the real wages of unskilled workers would rise with increased education spending. Thus, on the income side, improved skills would induce pro-poor growth and decrease poverty and inequality”* (Ianchovichia et al., 2004).

Through the WTO China gained access to secure, predictable and non-discriminatory markets of all WTO members, as well as nondiscriminatory access to goods and services. China’s commitment on international and domestic level to implement more transparent rules and regulations is noticeable. Increasing trade liberalization, stemming from reforms before and after WTO admission created widespread positive outcomes, which include a reduction in poverty and an increase in the HDI. However, current debate concerns the distribution level of these effects. Rodrik (2000) and Sicular et al. (2004) argue that the urban population, which is generally better positioned than the rural population, gains more from these developments, thus the income gap between the rural and the urban population is increased. At the same time, Dollar et al. (2001) argue that general positive impacts will spillover throughout the entire economy and create a more equal situation in the long-term.

Direct consequences for the domestic market following the WTO accession concern the removal of the quota system, which restricted exports for apparel and textiles, resulting in a rapid increase of the size of both industries: textiles increased by 32.7 percent and apparel with an astonishing 105.8 percent (Ianchovichian et al., 2004, p. 219). Additional developments included an increase in non-farm real wages, as unskilled agricultural labor shifted over to the textile and apparel sectors. Other economic sectors such as the automobile and electronic sector also experienced further growth, generating new employment opportunities especially for skilled workers.



*“With the promise to eliminate over the next few years most restrictions on foreign entry and ownership, as well as most forms of discrimination against foreign firms, China has set the stage for increase in foreign investment and productivity in these sectors. This in turn could lead to much larger income gains from WTO accession and larger increases in wages of skilled workers”* (Ianchovichian et al., 2004, p. 235).

Simultaneously, other estimates include over 6 million people leaving their farm jobs, moving to the non-agricultural sector. This represents the number of “*effective farm workers*” who were migrating from the rural to the urban regions based on the 2000 employment data from the Chinese Statistical Yearbook (2001, pp.111-112). This development went hand in hand with an increasing demand for labor in the nonagricultural sector, which triggered an increase of wages in the non-agricultural sector. Because the agricultural sector was now less protected, it became less attractive due to falling returns on labor and land. This caused a fall of 0.7 percent in real farm wages and of 5.5 percent in the real rental price of land. This shows two different wage developments between non-farm wages which increased with 1.2 percent, and skilled labor wages increasing with 0.8 percent, both indicating that the urban labor force as well as farmers who were able to change to non-farm employment, were the ones most profiting from China’s WTO accession (Ianchovichian et al., 2004, p. 220).

China’s accession additionally meant that world exports increased from 4.4 to 7.8 percent, while China’s imports increased from 5.8 percent in 2001 to 6.4 percent in 2007. However, it is necessary to state, that a large extent of China’s welfare gain resulting from the WTO membership was generated before 2001, as China prepared to fulfill the basic principles of accession. It is estimated that due to the massive liberalization of China’s economic sector between 1995 and 2001, welfare increased approximately \$ 31 billion of a total estimated \$40.6 billion. The reforms following the WTO accession were calculated to further increase China’s welfare with \$ 9.6 billion (Ianchovichian et al., 2004, p. 220).

## 5. China’s Future Direction of Economic Growth, Political Reform and Upcoming Challenges

After evaluating China’s recent developments it is now time to focus on upcoming challenges, which could create “speed bumps” in the country’s otherwise impressive economic developments. This paper will consider the following upcoming challenges in China’s future. At the same time, it must also be acknowledged that these challenges are not strictly Chinese, but that they can in fact be found in many other countries as well.

The main upcoming challenges for the future of China as mentioned by the interviewees, include:

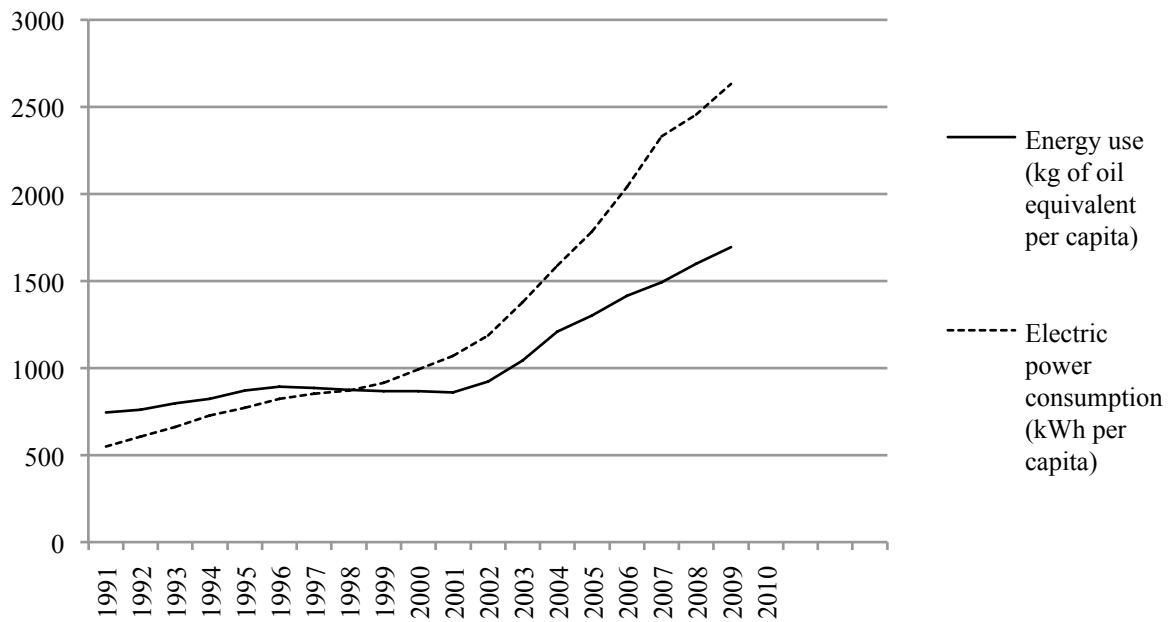
- China’s increasing demand for raw materials and resources as well as the increasing risk of a trade war;
- Economic espionage and the issue of Intellectual Property Rights (IPR);
- A weak legal system;
- China’s rising middle-class;
- The Chinese education system
- The demographic change in China as a direct effect of China’s One Child Policy
- Pollution, waste and the lack of corporate social responsibility

*“The same quirks and unfairnesses that would help it (the Chinese economy) withstand a shock in the next few years will, over time, work against the country. China’s phenomenal saving rate will start falling, as the population ages and workers become more expensive. Capital is also already becoming less captive. Fed up with the miserable returns on their deposits, savers are demanding alternatives. Some are also finding ways to take their money out of the country, contributing to an unusual downward pressure on the currency”* (The Economist, 2012 a).

## Interview 1: Energy and Pollution

As indicated by a manager of one of China’s leading petroleum companies, China’s increasing demand for energy is perhaps one of the biggest challenges for the Chinese economy. The past development of the Chinese economy and the resulting increase of living standards (as also indicated by an increase in the HDI) led to a massive reduction of poverty. At the same time, this led to an increasing demand for electronic devices including televisions, refrigerators, rice cookers, computers, mobile phones, air-conditioning and so forth. This rapid increase resulted in a vast increase in demand for electricity and oil (See graph 5). In order to supply the electricity demanded, on average one new power plant is built every ten days. Because China has large reserves in brown coal most of the power plants are generating electricity by burning brown coal. The problem with brown coal is that it has less energy than oil for example and thus large amounts of brown coal must be burned to generate enough energy. Brown coal is a bad alternative resource to generate energy, as it produces very high levels of pollution, which can cause extreme environmental damage. This pollution has a direct effect on air and water quality, whilst additionally influencing soil conditions. Due to weak environmental regulations further environmental damages are to be expected. Another challenge can be found in China’s increasing demand for oil and its expansion in Africa. China’s increasing role in Africa is creating a challenge for Western countries. China is the main supplier of a large extent of African resources, which together with China’s policy not to get involved with African politics, makes it an ideal partner for most African nations, especially those facing trade sanctions from the European Union or the United States. At the same time, the approach of not becoming involved in the political situation of other nations undermines Western sanctions and is thus generating trade advantages. In order to extract raw materials the Chinese government has invested heavily in infrastructure projects and therefore helped many countries including Angola to grow economically. This in contrast made Western countries increasingly unattractive business partners for many African nations and could have the potential to threaten their supply of resources (BBC, 2011; Nuer et al., 2011).

### China’s Consumption of Energy



Graph 5: China’s electric power consumption (kWh per capita) and the consumption of oil from 1991 to 2009 (World Bank, 2012, Data Set)

Therefore, trade tensions between China and Western countries could emerge, which could lead to trade wars, in which each party tries to protect national interests with military power. To avoid this scenario from happening, close collaborations between countries as well as the WTO could be of vital importance.

## Interview 2: Economic Espionage and the violation of Intellectual Property Rights

As indicated by a senior manager from a large international corporation (60,000 employees), which is heavily expanding in China, the issues of economic espionage and the violation of intellectual property rights (IPR) are to be taken seriously. China’s huge domestic market creates great business opportunities and attracts global companies from all different sizes and backgrounds. Once a company has decided to enter the Chinese market it is only a matter of time before a Chinese company starts copying the products often breaking with IPR regulations. This can create a short-term benefit for the Chinese market, but once this fraud is exposed it often damages business relations. This creates huge losses for companies and reduces the motivation for further research and development in China, due to the increasing risk of a violation of IPR. This creates a situation in which many of the large international corporations question China as a market and as a trusted business partner. In order to further illustrate this problem Microsoft is used as an example. Even though the US and Chinese market are comparable in size when considering sales, the Chinese market only generates 4 percent of the profits of the US market (2010). This drastically reduces returns per unit sold, which in return decreases the profitability of the Chinese market and foreign direct investment. The long-term damages for the Chinese market have the potential of being immense if international corporations discontinue their research and development in China. In order for China to become the strongest economy it needs to have its own research and development, and thus create a brand name in which customers stop associating China with a copycat economy. Made in China must stand for quality, uniqueness and innovation, a far cry from China’s current depiction.

In the Business Confidence Survey published by the German Chamber of Commerce in China (Press Conference Shanghai, June 27<sup>th</sup> 2012), 77 percent of the 258 foreign businesses included believed that an increase in IPR would have no changing impact. Instead there are only 0.8 percent who believe that an increase in IPR would have a significant effect, reducing the issue indicating high levels of uncertainty and distrust in the Chinese market place. As indicated before, the violation of IPR and the negative outlook for future developments concerning IPR must change in order to regain trust into the Chinese economy.

## Interview 3: the Legal System

*“A recent study of the role of law in China’s economic development concludes that it is impossible to make the case that formal legal institutions have contributed in any important way to China’s remarkable economic success. If anything, economic development has fostered the development of law, rather than the reverse.” Although we emphasize the causal priority of endogenous institutional change in the rise and diffusion of the private enterprise economy, transformative change giving rise to modern capitalist institutions relies not only on evolutionary bottom-up processes but also on state actors enacting and enforcing new formal rules in response to changing parameters in the real economy” (Nee et al, 2012, p.227).*

A manager of a medium size company located in Hangzhou highlighted the issues of the weak Chinese legal system. He explained that on several legal disputes between his company and a direct competitor, his company lost more than 90 percent of all disputes, even though the competitor was clearly in violation of his IPR. For him it seemed obvious that the court ruled in favor of the competitor, due to their strong connection to the local government. Having such a weak and biased legal system creates uncertainty for businesses and investments. Despite China’s impressive economic developments over the past three decades, China legal system will need to adjust to the increasing demands of the economic sector, especially the increasing private sector, which currently can be characterized as a legal insecurity. Furthermore a weak legal system, which is not guaranteeing that all parties will be treated equally despite of their connection to the government is needed to guarantee investments. If not, China’s economy could ultimately suffer from decreasing domestic investments and inflows of FDI, which in the long run could have a negative impact on China’s future economic growth. Throughout the political and economic developments as of 1978 the legal system responded to already established business practices, this can be seen for example in the development of the HRS (even if this was not passed as a law) and the emergence of China’s Stock exchange. Based on these developments, one could argue that, due to the increased importance of the private sector and China’s movement towards a market economy, the legal system will follow down the same path. This could indicate a fundamental shift within China, from a legal system governed by the rule of law towards the rule by law

## Interview 4: the Chinese middle class

*“Regulated interest rates enable banks to rip off savers, by underpaying them for their deposits. Barriers to competition allow the SOEs to overcharge consumers for their products. China's household-registration system denies equal access to public services for rural migrants, who work in the cities but are registered in the villages. Arbitrary land laws allow local governments to cheat farmers, by underpaying them for the agricultural plots they buy off them for development. And many of the proceeds end up in the pockets of officials” (The Economist, 2012 a).*

A senior member of the Swedish Chinese Chamber of Commerce stressed the increasing importance of China’s rising middle-class not only for China’s economic development but also for its political future. He indicated that China’s middle-class is growing annually with approximately 10 million people as a direct result of China’s economic reform process. Today’s middle-class is extremely well connected and demanding more political and economic freedom. Many members of the middle-class are private entrepreneurs, who achieved their success without any support from the government. In fact the opposite is the case. Therefore, they feel that the government is working against their economic success by continuously discriminating them as private entrepreneurs. Thus, the middle-class demands of more political and economic freedom and their increasing numbers has the potential to become a constant challenge to the Chinese government.

The notion has been raised that the only chance for the CCP to surviving in the future is to secure economic growth, which leads to a further increase in the HDI and therefore increases the standard of living of the Chinese people. To do so, the reforms initiated during the past three decades can only be the beginning of a process of transformation, which allows the Chinese economy and especially the private sector economy equal rights, thus granting the Chinese people the right to become more involved in political decision-making. This ironically is only the case if the CCP allows for opposition and the acceptance of basic human rights, such as the right for free speech and a decrease in censorship allowing the access to critical media, which would clearly threaten the existence of the CCP itself.

## Interview 5, 6, and 7: the Education System

As mentioned by a member of the German Chamber of Commerce in China Shanghai, as well as senior managers of international corporations, China’s education system is producing massive amounts of university graduates. Despite their high level of education there is still an unemployment rate of academics between 15 to 20 percent, even though there is a general increase in demand for well-educated people within all economic areas. This can be partly explained by their inability to work individually and innovatively. Because of a shortage of well-educated people, future economic growth might be restrained. A well-educated workforce is of vital importance to China’s future growth plan and its chance to further catch-up with other economies. Other challenges besides finding qualified staff, concerning China’s workforce, include increasing labor costs, and the retaining of the quality of the labor force.

As a survey by the German Chamber of Commerce in China (press conference Shanghai, 27<sup>th</sup> June 2012, Business Confidence Survey) has indicated, 84 percent of 230 foreign companies included in the survey identify the lack of qualified personnel as a major draw back for further economic expansion. As the survey indicates, the lack of producing the right workforce could severely damage China’s future in innovations and developments, thus threaten future economic growth which then again could lead to social unrests as previously indicated in interview 4.



## Interview 8: One Child Policy

In order to compare economic change, GDP per capita is the most efficient way of measuring development. That includes all goods and services produced in the economy within a fixed timeframe (usually one year) divided by the total population of the country. There are two ways, which have a positive impact on the GDP per capita growth rate. The first one is increasing economic growth while the total population of a country stays constant, or decreasing economic growth by controlling the country’s fertility rate. The second way of increasing GDP per capita is when the economy growth faster than the country’s population. The aim of Deng Xiaoping’s reform process in 1978 was to do both. On the one hand control China’s population growth by introducing family planning and birth control, and on the other hand economic reforms, which also led to economic growth. The result was China’s one child policy (1979), which was implemented to “*control overpopulation, reduce the depletion of natural resources, and reduce the unemployment of surplus workers*” (Grivoyannis, 2012, p. 11). China’s economic challenge was the diminishing marginal productivity of labor, due to rapid population growth, while China’s physical capital grew much slower. This in turn decreased labor productivity, which meant that each farmer was less productive in producing food. If China’s population would continue growing with a fertility rate close to 6.0 this would reduce the savings rate and capital accumulation (Grivoyannis, 2012, pp. 12-15). The only way for China to counter steer these developments was to increase family saving, which would only be possible if the average family number would decrease.

*“It was becoming obvious that the only way to accumulate capital and increase labor productivity and family wealth was to curtail population growth. A reduction in the population growth policy, therefore, a necessary condition for China’s growth in her per capita GDP”* (Grivoyannis, 2012, p.12).

The one child policy was introduced “as the only scientific way out of China’s demographic impasse” by Song Jian (Greenhalgh, 2005). The response to the one child policy was very different between the rural and the urban population. For the rural population a big family with lots of children would often be necessary to handle the huge work load and maintain the farm “*and support them in their old age*” (Grivoyannis, 2012, p.13). Because of the resistance of the rural population, people were allowed to have a second child if their first one

was handicapped or a girl. Once married the girl would leave and live with her husband's family and therefore could not support the parents in their old age. The urban population was more welcoming to the one child policy, due to high living costs associated with living in an urban environment and it giving them an opportunity to show their support for the communist party by only having one child.

*“Last year the ranks of working-age Chinese fell as a percentage of the population. Soon their number will begin to shrink. The minority who remain in China's villages are older and less mobile. Because of this loss of demographic momentum, China no longer needs to grow quite so quickly to keep up. Even the government no longer sees 8% annual growth as an imperative. In March it set a target of 7.5% for this year (2012), consistent with an average of 7% over the course of the five-year plan that ends in 2015. China has been in the habit of surpassing these “targets”, which represent a floor, not a ceiling to its aspirations. Nonetheless the lower figure was a sign that the central leadership now sees heedless double-digit growth as a threat to stability, not a guarantee of it”* (The Economist, 2012 b).

On average, as a result of the one child policy, the Chinese society is increasingly ageing which leads to demographic change in China (as indicated in table 6). This indicates, that there will be less young people who can take care of the aging population, which is also referred to as the “4-2-1 Problem”. It states that one adult will have to take care of his two parents and his four grandparents. The side effect of this is that the savings rate has increased for people with only one child, as they have realized that they cannot depend on their only child to take care of six people, whilst also realizing that they are actually saving money by only raising one child (Grivoyannis, 2012, p.13).

*“As China is transitioning into an industrial giant, the capital-labor ratio is rising and the importance of the population fertility rate has altered. China became engaged in the unpleasant task of controlling population growth by force in the hope of increasing wealth and preventing economic collapse and society breakdown. It seems, though, that wealth creation in the future could be enhanced by a slightly higher population growth than the current one”* (Grivoyannis, 2012, p.14).

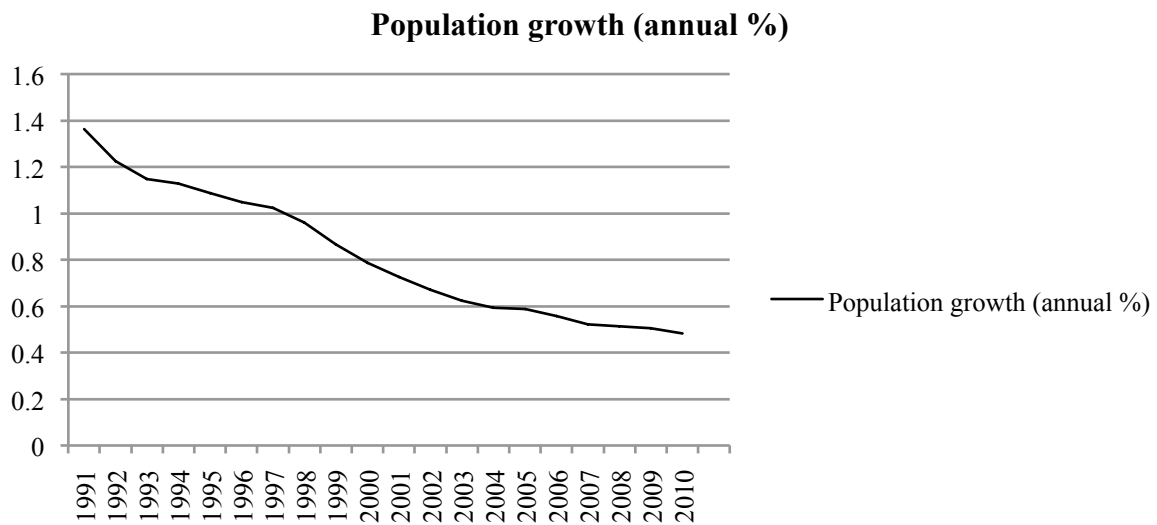


Table 6: China’s change in population growth in percent from 1991 to 2010, (World Bank, 2012, Data Set)

As indicated by a senior manager of an large international corporation and underlined by Grivoyannis (2012, pp.14) a challenge for China’s economy is the development of labor costs created by the one child policy. Until today China’s surplus labor led to low labor costs, allowing China to have a labor-intensive production, which attracted FDI, creating a comparative advantage in labor costs compared to may developed countries. Also China’s strong economic growth prevented prices from drastically increasing, keeping domestic consumption goods at an inflation rate of 1.9 percent, which support the export sector. This is bound to change as it can be observed by rising wages of between 6 and 10 percent for Mainland China in 2010. The strong increase of wages can be explained by China’s strong economic growth also increasing the demand for labor on the one hand, and on the other hand a shortage of labor created by the one child policy. This led wages as well as commodity prices to increase and hence threatening China’s comparative advantage in labor-intensive production (Grivoyannis, 2012, pp.14).

## Conclusion

The analysis of this paper has highlighted China’s opening in 1978, also known as “*Gaige Kaifang*” and has supported the idea that a new political elite has been created. China’s accession to the WTO, the shift from a centralized planned economy towards ‘Federalism Chinese Style’, fiscal decentralization and the increasing acceptance of the private sector all underline this development.

Returning to the initial research question if there is a relation between the liberalization of China’s political sector, which shows grassroots democratic development and its economic growth, one must divide the answer into different parts. If one is only looking at the economic impact of grassroots democratic institutions, which can be found on the village level, one cannot make the case that they have a significant impact on economic development. In fact, elections on the village level form a paradox within the political system. In order for politicians to stay in charge on the village level they need to be reelected and this is only the case if the people are satisfied with the work done. A not functioning political system on the village level will simply not be reelected; therefore efficiency on the village level is sovereign. The paradox is that this democratic practice, of having elections, is not found at higher political levels in China. At the regional or city level, the case can be made that political liberalization, which followed the open door policy in the 1980’s, has had a positive effect on economic development, but it is not the effect of a democratic development. Instead economic development is most likely a result of the region creating a friendly business environment to attract business and investment. On the provincial level economic reforms, such as Federalism Chinese Style, which were triggered by the political elites such as Deng Xiaoping, led to economic growth. Still there is no evidence that a democratic development would support economic growth on China’s provincial level because all reforms made are strictly economic reforms and not political.

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# Appendices

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### **Great Leap Forward 1958 - 1960**

The Great Leap Forward (1958 – 1960) was initiated by Mao Zedong and followed a system that “*emphasized decentralization of ownership and decision-making by communes while it ideologically tried to inspire higher productivity across all sectors of the economy*” (Grivoyannis, 2012, p. 2). This led to the collectivization of farms and a labor-intensive industry. The shortage of capital and bad weather conditions drastically reduced the food production, which resulted in the biggest manmade famine in history killing 45 million people from starvation.

### **Cultural Revolution 1966 - 1976**

In the ten years of the Cultural Revolution (1966 – 1976) universities were closed and members of the Chinese People’s Liberation Army replaced company managers and engineers, which led to inefficiency within the economic sector. In addition to this the foreign technology was no longer imported which further reduced economic growth. Roughly 2 million people were declared as enemies of the new established communist system and were killed by Moa Zedong’s movement of the Cultural Revolution (Grivoyannis, 2012, p.4).

### **Deng Xiaoping – Southern Tour**

In 1992, Deng Xiaoping traveled through southern China promoting the importance of economic reforms at the same time as he was criticizing those who were standing in the way of further economic reforms. One result of his tour was the broader acceptance of the private sector, which as a result lost its stigma as being capitalistic. Later this tour became also known as “the Southern Tour”, or “Deng’s tour”.

### **An Overview of China’s Reform Process from 1978 – 2012**

In the overview below, a rough timeline of China’s reform process from 1978 – 2012 is presented:

The first period of the door policy 1978 – 1997:

- 1978: China’s opening, Socialism with Chinese characters, Household Responsibility System, establishment of Township Village Enterprises (TVE) and State Owned Enterprises
- April 1980: China becomes a member of the International Monetary Fund (IMF)
- May 1980: China becomes a member of the World Bank
- August 1980: the government establishes four special economic zones: Zhuhai, Xiamen, Shenzhen, and Shantou in order to attract foreign direct investment (FDI) but at the same time to control the impact of foreign firms on the Chinese economy.
- 1981: Household Responsibility Reform, which allows farmers to retain the surpluses generated and by doing so creates a new incentive structure.
- 1982: 6<sup>th</sup> five year plan published under the full leadership of Deng Xiaoping, Hu Yaobang and Zhao Ziyang with the goal of pushing China towards a market economy with Chinese characters and sustaining growth.
- 1984: the opening of 14 coastal cities as well as 3 regions as open areas for foreign investment with the intention to further attract FDI by allowing for special benefits within the regions such as tax benefits, and downsize planned allocation all enhancing market economic developments
- 1986: the passing of the so called “General Principles of Civil Law” that provided the basic legal principles based on the 6<sup>th</sup> five year plan for the operation of a market economy, Labor Contract System enabling the company managers to lay off workers
- 1987: the private sector was recognized as a necessary supplement, to the otherwise state controlled economy by the Thirteenth Congress of the Chinese Communist Party
- 1988: first time liberalization of the company law, which allowed the registration of other company forms besides state owned and created the legal beginning for the opening up of private firms
- 1989: special economic zones and technology parks as specific development tools to drive research and development as well as innovation are established. This is seen as a way to attract FDI by allowing tax incentives for specific branches within the framework of national industrial policies
- 1989: Tiananmen Massacre
- 1990: opening of the first Chinese stock markets in Shanghai and Shenzhen



- 1992: Socialist Market Economy with Chinese Characters is being announced by the Fourteenth Congress of the CCP as the goal of the reforms
- 1993: The Contract Law, Company Law and the Banking Reform were initiated
- Since 1993: Property Approach; partial and full privatization of SOE’s, founding of joint stock firms and limited liability companies
- 1994: Company Law as well as nationwide liberalization by the CCP opens all of China, not just the coastal regions for trade to attract FDI
- 1995: implementation of the Chinese Labor Law, which allowed managers to “cut down on manpower when a firm runs into economic difficulties” (Art. 27)

### **An Overview of China’s Commercialization Stage since 1997**

In the overview below, a timeline of the reform process, which is also being referred to as China’s commercialization stage since 1997 is presented:

- 1997: The Price Law is passed, which states that the prices are set by the market but that the CCP has the right to intervene, which was a pre-requirement for China to be accepted as a WTO member; Property Rights are reinforced
- 1998: Security Law is passed
- 2001: China becomes a member of the World Trade Organization (WTO); private entrepreneurs can now become party members; trading restrictions are dropped which now allow residents to also trade B-shares on the stock market
- 2003: China is opening the financial sector even further and now allowing foreigners to also trade A-shares
- 2004: The Constitution is changed to provide support for the protection of private property
- 2006: Social Security Law is initiated
- 2007: Property Law is initiated, now it is up to the state to determine to what extent property rights may be recognized and enforced; The level of enforcement varies and is highly dependent on state or social interests.
- 2008: Just prior to the Olympic Games hosted in Beijing anti China protests escalate and turn into the worst clashes between pro-Tibet activists of the past two decades

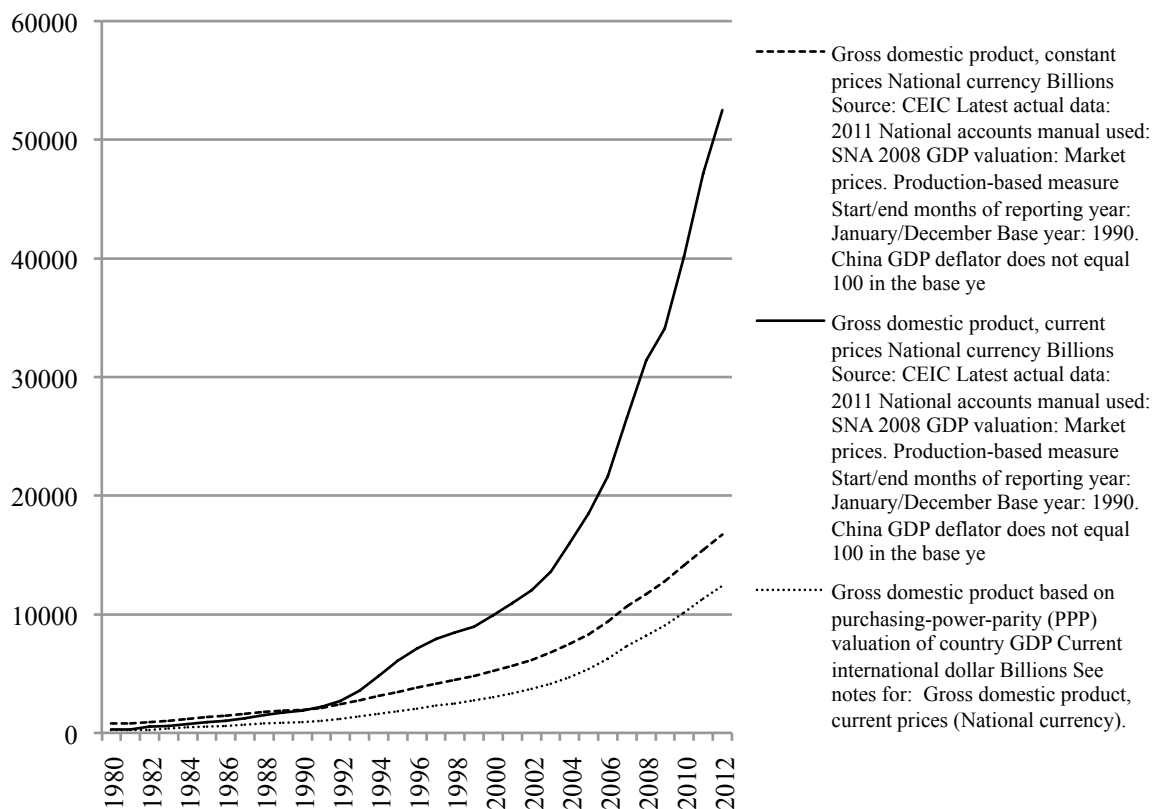
## An Overview of the Global Financial and Economic Crisis as of 2008

In the overview below a timeline of the outbreak of the Global Financial and Economic Crisis as of 2008 is presented:

- 2008: the Government announces a \$586 bn stimulus package
- 2010: China overtakes Germany as the world’s biggest exporter
- 2011: China overtakes Japan and is now the second largest economy after the USA

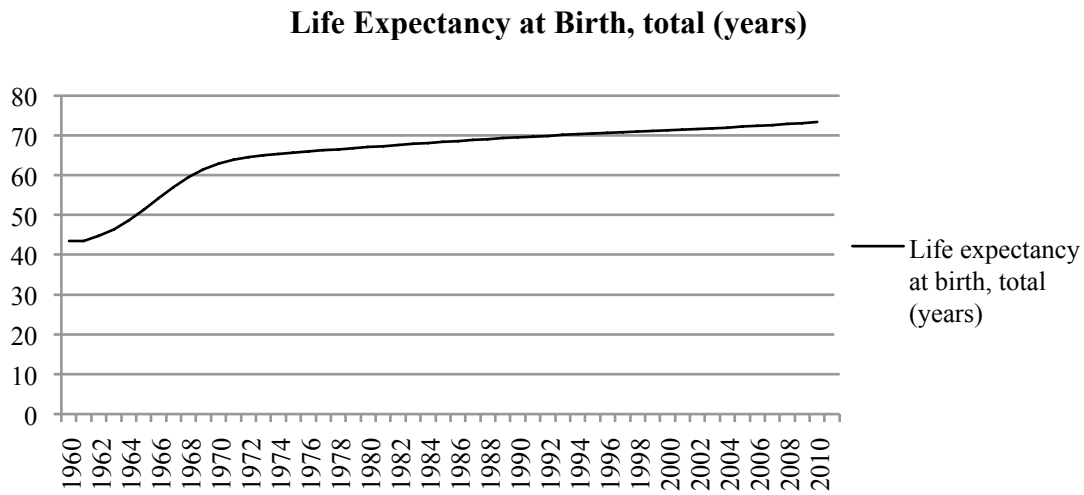
## China’s Economic Development from 1980 – 2012

### China’s Economic Development from 1980 - 2012



China’s economic development measured in GDP from 1980 – 2012, (Source for Data IMF)

### Life Expectancy at Birth, total (years)



The development of life expectancy in China from 1960 to 2010, (World Bank, 2012, Data Set)

### China’s annual Percent GDP Growth from 1960 – 2010



China’s economic development presented as annual GDP growth in percent from 1960 – 2012, (World Bank, 2012, Data Set)

### Map of the People’s Republic of China



Map of the People’s Republic of China available at: <http://www.chinahighlights.com/map/>