Macalester International

Volume 18 *Chinese Worlds: Multiple Temporalities and Transformations* Article 18

Spring 2007

China's Authoritarian Market Economy

Gary Krueger
Macalester College

China's Authoritarian Market Economy

Gary Krueger[1]

I. Introduction

After three decades of isolation under Mao, the Chinese economy has undergone what is arguably the most profound economic transformation in the last several centuries. In Mao's China, the economy was classified as primarily agrarian and socialist. The post-Mao Chinese economic system ("Dengism"), in which public ownership remained significant, at least early on, but allocation of resources took place mostly via the market, presents some significant challenges in the field of comparative economic systems. What exists today is an economic system in which the market, albeit with increasing private ownership, dominates the allocation of resources, but which operates under an authoritarian political system. This results in an unusual political and economic structure that has some obvious benefits and largely hidden costs.

This article endeavors to address some of the challenges China's unique economic system poses for comparative economists, and in the process to shed light on the enigmatic character of China's current economic arrangements. The central thesis of the essay argues that the combination of a market economy with an authoritarian political system has some distinct advantages as a developmental economic instrument, but it also has significant disadvantages that may become increasingly obvious as China's economy matures.

The essay is divided into four sections. Following this introduction, Section II introduces the basic field of comparative economics and the generally accepted tools of economic classification. Section III provides a basic background of China's economy under Mao and a brief outline of the reforms enacted under Deng. Section IV discusses the uniqueness of the authoritarian market economy and provides some concrete examples of the operation of China's economy based on my independent research in a newly privatized poultry producer and an examination of the Three Gorges dam project.

II. Comparative Economic Systems

Historically, the field of comparative economic systems relied on ownership, public versus private, as a first approximation of categorizing economic systems. Generally speaking, the ownership mechanism was closely linked to the dominant form of allocation: central planning or market. Under this system the United States was classified as a capitalist (private ownership of the means of production) market economy and the Soviet Union was a socialist (public ownership of the means of production) centrally planned economy. Of course economic arrangements and economic systems were never monolithic and public ownership of significant fractions of the economy exists in capitalist market economies while private ownership and market mechanisms are frequently used in (generally isolated) sectors of socialist planned economies.[2]

Although the field of comparative economic systems tended to ignore the political structures associated with market/capitalist and planned socialist economic systems, capitalist market economies tended to be dominated by parliamentary or representative democracies, while socialist planned economies were governed by authoritarian communist dictatorships. Exceptions were, of course, Nazi Germany during World War II, in which resources were generally privately owned, but allocation decisions were closely controlled by the state as in a centrally planned economy; and the military dictatorships of Latin America in which private ownership and market allocation coexisted with an authoritarian political system. In this respect, on the face of it, China today appears closest to the Latin American model than any other alternative.[3]

Within the set of each basic category of economic system important differences exist. Among the capitalist market economies, continental Europe and Japan tend towards significant government intervention in the economy, either overtly or relying on more subtle means. The

United States and the United Kingdom (especially under Margaret Thatcher) avoid direct intervention in the economy whenever possible and instead prefer adjustments in the "rules of the game" when problems arise. Among the Socialist planned economies similar variations existed. In Hungary central planning was eliminated at the wholesale level in the late 1960s, while in Poland collectivization of agriculture was abandoned in the late 1950s.

III: China's Economy since 1950

While the Nationalist Chinese were defeated in 1949, the Chinese effort to build a socialist economic system did not begin until the end of the Korean War in 1952, with the adoption of the first five-year plan, which was to run until 1957. Not surprisingly, given the absence of clear alternatives, China's initial attempts at constructing socialism were patterned closely on the Soviet economic model. The first five-year plan was heavily influenced by the legions of Soviet advisors who were responsible for much of what was to become the Chinese economy. Large state-owned industrial enterprises, controlled from Beijing, were established, agriculture was collectivized, and private ownership abolished. In the plan itself, priority was directed toward firms in heavy industry at the expense of agriculture and consumer goods industries. The role of money in allocating resources was reduced or eliminated, and trade with Western market economies was curtailed significantly.

Due in part to the Sino-Soviet split of the late 1950s, and more importantly to the discontent with the results of the first five-year plan, in 1957 China embarked on its own, uniquely Maoist, path. The primary source of discontent with the first five-year plan was the sense that Soviet-style heavy industry was ill suited to China's mostly rural and peasant-dominated economic situation. The official policy change was known as "the Great Leap Forward," a central feature of which was reprioritizing the agricultural and rural economy and deemphasizing heavy industry. It was during this period that a uniquely Chinese, or Maoist economic system began to emerge. A central feature of Maoism was "self-reliance," in which China sought independence from foreign economic engagements. The concept of self-reliance was taken to extremes during the Great Leap Forward under the strategy of "walking on two legs," in which the rural agricultural sector was to operate independently of the urban industrial sector.[4] The classical manifestation of this policy was the well known "backyard steel furnaces," in which collective farms made their own steel from primitive ovens. In addition to operating independently of the urban industrial sector, self-reliance was taken further. At the "brigade" level of collective farms, individual brigades were to operate more or less independently of each other.[5]

To those familiar with basic principles of economics, one might anticipate the outcome of Maoist-type reforms, and the Great Leap Forward did not fail to deliver, resulting in massive famine in which millions starved. Much as Lenin did in the mid-1920s in the Soviet Union, Mao was forced to backtrack on his reforms and under the guidance of Liu Shiao-Chi and his then-deputy Deng Xiaoping, more market-oriented reforms were implemented in the countryside, and by 1963–64 the economy recovered.

The improved economy emboldened the core left-wingers in the Communist Party, so Liu Shiao-Chi and Deng Xiaoping were denounced as "capitalist roaders" and purged from their leadership positions. China receded into the morass known as the "Cultural Revolution," which lasted from 1966 to 1976 and the death of Mao. Not surprisingly, given the political instability and the disastrous economic policies, the Chinese economy, as measured on a per capita GDP basis, was stagnant from 1952 to 1976. That is, growth in per capita GDP was basically zero for 25 years.

With the demise of the Gang of Four and General Secretary Hua Guofang, Deng Xiaoping emerged as the undisputed leader of the Communist Party of China in 1978. Deng sought to quickly end the economic stagnation under Mao, embarked on the "Four Modernizations," and implemented the "Rural Responsibility System" (later to be known as the "Household Responsibility System" or HRS), in which rural peasants or groups of peasants could lease land from the collective for five- and later for 15-year periods.[6] Leaseholders were allowed to keep any residual earnings they possessed after payments for materials and rents to the collective farm. Participation in the HRS mushroomed. By 1983, 99 percent of peasant farmers were leasing their land independently from the collective.[7]

The advantages of specialization and trade in agriculture and the improved incentives for farmers resulted in robust increases in farm income in the first half of the 1980s, which farmers promptly plowed back into purchases of goods and services from the local township and village enterprises (TVEs). While the growth in agricultural income stagnated in the second half of the 1980s, the growth in the quasiprivate TVEs was astounding, averaging nearly 25 percent per year, with productivity growth at 22 percent per year from 1980 to the mid-1990s.[8]

Coupled with the HRS, the late 1980s and early 1990s witnessed the significant opening of the economy to foreign firms. Initially in Shanghai and in Guanzou (bordering Hong Kong) foreign firms were allowed to set up joint ventures in so-called "Special Economic Zones," which allowed foreign firms to keep their profits and also to own up to 49 percent of the joint venture.

In the immediate aftermath of Tiananmen Square, foreign involvement in the Chinese economy cooled, as did economic growth. Inflation also rose dramatically in the early 1990s as the central government was starved for revenue while still spending to support the socialist sector of the economy.[9] In the mid-1990s the privileges that were formerly confined to the Special Economic Zones were broadened to include the entire country, and foreign firms were permitted to own their own facilities without the necessity of a Chinese partner or the restriction that they own less than half of the joint venture.

Not surprisingly, foreign investment in China exploded, as did economic growth, this time without the inflation of the early 1990s. Economic growth continued without pause for the first half of this decade and the Chinese government continued its path toward economic liberalization, eventually meeting the requirements for WTO admission by 2002.

IV. China's Authoritarian Market Economy

The unique history of China—from stagnation and turmoil to sustained economic growth at unprecedented levels—raises important issues for students of transition economics in particular, as well as more generally for those interested in the process of economic development *per se*. For transition economists, China is often held up as a "gradual" reformer. Given the excellent performance of China, the gradual transition to a market economy is clearly preferable to the "Shock Therapy" adopted in the former USSR and Central Europe, both of which had greater difficulties in the transition to a market economy.

While these views are often repeated in the popular media and academic journals, the characterizations of China as gradualist and Russia as pursuing Shock Therapy are problematic. If we consider the cornerstone of Dengism to be the HRS—and note that it was effectively introduced and penetrated the entire agricultural system in four years, or about the same time it took for Stalin to complete his collectivization of agriculture—then the "gradual" nature of Chinese reform does not appear all that gradual. At the same time, Russia did not adopt a law permitting the ownership of agricultural land until the year 2001, ten years after the fall of communism, and even then foreigners are not permitted to own land.

So while we may dismiss the gradual versus shock therapy debate when looking at China, we cannot so readily ignore the possibility that China's authoritarian political structure is beneficial to economic development, and possibly also to the transition process itself. Generally speaking, authoritarianism is regarded by economists as detrimental to the development process for several reasons. First, authoritarian governments tend to lack self-restraint in matters of corruption and contract enforcement, which reduces investment from the domestic private sector and foreign firms. Second, McGuire and Olson have shown that relative to democracies, authoritarian governments have an incentive to under-invest in public goods and extract more revenue from private citizens than would democratic systems.[10] Finally, authoritarian governments may be unstable, or at least their laws and edicts are more likely to change quickly than in a democratic system, once again reducing the incentive for investors, who tend to shy away from instability when investing their assets. On the other hand, there are some clear advantages to a streamlined decision-making process generally associated with authoritarianism, including the ability to concentrate and marshal scarce resources quickly.

A. Evidence from Three Gorges

The central question as to the efficacy of the authoritarian market economy is the degree to which authoritarian governments can exercise self-restraint and therefore avoid the disincentives to investment, while at the same time obtaining the advantages of the ability to set priorities and concentrate resources quickly. Additionally, authoritarian systems are generally more empowered to undertake large "gigantomania" projects that are less likely to receive support in democracies. Assessing the costs and benefits of these projects is extremely difficult. Authoritarian systems often err, underestimating the true costs and overestimating the benefits, leading to the creation of "white elephants."[11] The Three Gorges dam provides an excellent example of a massive scale project that arguably could only have been executed in an authoritarian political environment.

While the prospect of building a large dam to control the periodic flooding of the Yangtze and its tributaries had been under consideration for most of the 20th century,[12] serious planning and construction did not begin until 1993. The dam itself is one of the largest in the world, and its primary function is to provide flood control for the Yangtze River below Yichang by raising the water level above Yichang from 63 meters to the eventual level of 156 meters in 2008. At its current level of 135 meters, it is now possible for barge traffic of significant scale to reach into the heart of Sichuan province and the Chongqing special administrative district, which is home to 25 million people and a key element in Beijing's effort to promote economic development away from the heavily populated coastal regions. Finally, the dam will provide 18,200 megawatts of much needed hydroelectric capacity for China's increasingly energy hungry economy.[13] In terms of flood control, the Three Gorges dam will protect the large cities of Yichang, Wuhan, Nanjing, and Shanghai, home to approximately 400 million people. While Shanghai has not flooded since the 1970s, Wuhan has flooded severely in 1998, killing an estimated 4,000 people.[14] Nanjing was severely threatened with flooding in 2002.

While there are indeed tremendous benefits to the project, there have been tremendous costs. Leaving aside the cost of the dam itself (estimated to be in the vicinity of U.S. $25 billion[15]), the flooded area in Sichuan requires the relocation of up to 1.3 million people, the elimination and removal of numerous cities and towns, and the loss of considerable cropland throughout the entire river basin, including its countless tributaries. Less directly observable costs include the construction of massive retaining walls in every major city and town to prevent soil erosion and landslides. These retaining walls are of significant scale and are intended to protect almost 100 meters of riverbank, up to 175 meters above sea level, in cities and towns throughout the river basin, all of which need to be completed before the basin is filled to 156 from its current level of 135.

While cost estimates are uncertain—it is highly doubtful that anything close to the true economic costs of the project are known or knowable—one can make the argument that the benefits of the project probably outweigh the costs.[16] Assuming for the sake of argument that this is indeed true, the central question is whether this project could have been implemented in an alternative political environment? In other words, is it conceivable that this project could emerge from a democratic political process?

If we look around the globe at democratic market economies, we do see large projects that have transformed significant regions; examples include the "Big Dig" in Boston, the Euro Tunnel connecting England to the continent of Europe, and the U.S. interstate highway system. Although these projects are all of significant scale, they differ from the Three Gorges in significant ways. The Big Dig and the Euro Tunnel, while large, required relatively little relocation of citizens, thus reducing political opposition from those most directly affected by the project. While the interstate highway system involved significant disruption and the relocation of many people in mostly poorer neighborhoods, the impacts were diffuse regionally and spread out over a period of several decades while the system was under construction. By contrast, the Three Gorges dam was mostly completed a little less than a decade after construction began in 1997. However, like the Three Gorges project, the cost effectiveness of these massive projects is always difficult to discern, and rarely (if at all) do the benefits significantly outweigh the costs.[17]

The advantages of the authoritarian system over democratic systems appear to be the ability to entertain a greater number of projects of a scale that developed market democracies generally cannot, especially if they affect large numbers (millions) of citizens, as well as to accomplish the project as rapidly as technologically possible. However, much like the Euro Tunnel, the Three Gorges dam may prove to be less beneficial than anticipated. Sedimentation at the base of the dam may reduce flow through the hydroelectric generators and the lifetime of the dam from 100 years to something substantially less. Already problems with soil saturation and the resulting landslides at the current level of 135 meters have occurred, with the possibility of more to come as the water level is increased. The lack of sedimentation at the mouth of the river in the East China Sea is already threatening the shoreline near Shanghai, possibly requiring costly levies and dikes to protect the city. Finally, there is a risk of dam failure due to poor construction. Much like the Big Dig in Boston, corruption plagued the Three Gorges dam in the early part of the century and it is unknown if the project meets all required design specifications. Finally, although the Three Gorges dam will prevent flooding from the Sichuan basin upstream, the river system below the dam may still threaten the area around Wuhan, home to eight million people. Much as in the SARS outbreak in 2004, if any of these events come to play it is unlikely that China's authoritarian government will recognize them until the situation is out of control.

B. A Privatized Poultry Firm

As noted earlier, the township village enterprises were an important source of economic growth in the first two decades of Dengism. As also noted, the TVEs remained a unique feature of China's economy, enjoying a status somewhere in between private and public ownership, and facing considerable competition from TVEs in adjacent regions. Despite the success in productivity and growth, it is not clear if most TVEs were profitable in the sense that they covered the costs of their capital. The primary reason for this opacity was the banking system in China. Banks were controlled by the government, and household deposits were channeled to whichever government projects seemed most worthy. Local governments, therefore, had significant influence as to the investment resources available to the TVE, which could be used to cover losses, even though the firm was growing rapidly.

Beginning in 2000 this began to change and TVEs were privatized and local government removed from control of TVE management. In Shanghai I had the opportunity to interview the president of a newly privatized poultry producer/processor. The firm is one of the largest suppliers to YUM brand's Kentucky Fried Chicken, the largest fast food network in China.[18]

The firm is located in Shangdon province to the south of Beijing, and employs 1,000 full-time and 6,000 part-time employees. The current level of employment represents a 250 percent increase in overall employment since privatization in 2001 and a doubling of full time employees. Since 2001, the firm has registered substantial increases in total production, raising the number of chickens processed per day from 70,000 to 200,000 and introducing new production in ducks, of which the firm currently processes 50,000 a day (from zero in 2001). Compared to the overall economy that has been growing at 8–10 percent per year since 2000, the poultry producer is growing some 3–4 times faster.[19]

In terms of overall finances, the firm pays respectable wages of 1,200 yuan per month (based on average piece work per person) which translates to $1,800 per year at market exchange rates, but when adjusting for cost of living is closer to $5,000 per year. It is also worth noting that the firm provides free housing and uniforms to its workers. Prior to privatization, according to the President, the firm was not profitable: "We did not run well in 2000, which was the main reason we needed to be privatized." In 2006, the firm was earning 15.8 percent return on investment, and on sales of 1.58 billion yuan the firm made 80 million in profit.

Given the rapid growth of YUM in China, accounting for up to one-third of YUM brands total profit worldwide, the demand for poultry remains strong.[20] According to the President of the company, in order to keep pace with growth in YUM's China operations, the firm plans to double capacity in the next five years. The expansion is to be financed out of retained earnings, bank loans, and possibly a foreign investor.

This post-privatization success is no doubt related, in part, to the tight governance structure of the firm. While most of the 500 full-time workers owned shares at the time of privatization in 2000, the vast majority of shares are concentrated in top management. Since privatization, ownership has been further concentrated as workers sold their shares to management. The Chairman of the Board, the former plant manager, owns 40 percent, the President 12 percent, and the two remaining members of the Board own 16 percent. Middle managers control an additional 32 percent. By transition economics standards, the firm's ownership structure is very concentrated and appears to be closer to a limited partnership/sole proprietorship than a publicly traded company like one sees in developed market economies. To summarize this case study: on the one hand, the firm has grown significantly, is now profitable, and is planning on significant expansion; on the other hand, the distribution of ownership has become significantly more unequal and the role of the local government has been eliminated in the operations of the firm.

V. Conclusion

The large Three Gorges project and the newly privatized poultry producer provide interesting contrasts into the future of China's economy. While the Three Gorges project is an amazing accomplishment and is more likely than not to yield benefits in excess of costs for many years, it arguably could only have happened under an authoritarian government. The question remains whether China will need another project on the scale of the Three Gorges. If not, then the benefits of the authoritarian economic structure as an instrument of development might be in the past. The vitality and profitability of the poultry producer, while no doubt due in part to rapid growth in the economy, is also attributable to the positive incentives of privatization and ownership. Of course, the positive-incentive effects of private ownership require that governments respect property rights. Enforcement of property rights presupposes self-restraint on the part of government, which is fundamentally at odds with an authoritarian regime. In effect, the different levels of government appear increasingly willing to exercise self-restraint in exchange for improved economic performance in the private sector. Yet this "self-restraint" tends to be imposed from Beijing rather than organically, or voluntarily, originating at the local government level. So while the future of the authoritarian government structure in China appears in doubt, the transition to a more democratic system may not happen smoothly. Rather, tensions between Beijing and regional governments are likely to increase significantly in the next decade. ◉

Notes

1. The author wishes to thank the Macalester College Faculty Development International Seminar for making this research possible. Special thanks go out to Xi Luo and Holly Barcus for comments and research support on this project. Errors are the responsibility of the author.

2. For example, under the most severe periods of Stalinism, rural peasants sold surplus crops in a free collective-farm market. Throughout most of Soviet history, labor was allocated via a quasi-market mechanism. See Granick 1987.

3. Yet the performance of the Chinese economy has been astounding while the economies of Latin America mainly stagnated for most of the 20th century. This article examines some important differences that may explain the variations in performance.

4. See Eckstein, Chapter 2, for an excellent description of the Great Leap and Maoism.

5. Under Mao, Chinese collective agriculture was organized in a hierarchy beginning with the household, groups of households (teams), groups of teams of approximately 1,000 people (brigades), and communes (groups of brigades). Communes later became the Townships and Villages, which we see today.

6. At this time Deng is reportedly to have said, "It does not matter if a cat is white or black as long as it catches mice."

7. See Naughton 1995, p. 141.

8. Weitzman and Xu refer to the TVEs as a "vaguely defined cooperative" in which the owner is the local village or township, but the profits are shared among the local government, the workers, and the managers of the firm. Weitzman and Xu 1994.

9. Central government revenue as a fraction of GDP fell to less than 3 percent in 1993. See Gordon and Li 2002, p. 20. By comparison, the federal government of the U.S. collects approximately 20 percent of U.S. GDP.

10. McGuire and Olson 1996.

11. The official web site of the Three Gorges project lists only benefits of the project and makes no mention of the monetary costs.

12. The original proposal to build a large dam on the Yangtze was made in 1919 under Dr. Sun Yat-sen.

13. For comparison purposes, 18,200 megawatts is about the electric capacity of the greater Chicago area.

14. An additional benefit of the dam is the economic and other forms of development along the riverbanks of these cities. In Wuhan there is now a sizable park that runs for miles along what was periodically flooded and undeveloped territory.

15. Both the International River Network and Wikipedia.com cite the $25 billion figure, while Morimoto and Hope use $50 billion in their more sophisticated cost-benefit model. The $25 billion is the figure most frequently cited, but this appears to include only the direct costs of the dam and most likely does not include the indirect costs of retaining wall construction and the relocation of 1.3 million citizens.

16. Morimoto and Hope calculate that the benefits will outweigh the costs after 25 years and will continue to add $50 billion to national income for 75 years thereafter. They estimate that there is a 5% chance, however, that throughout the entire 100-year life of the project, costs exceed the benefits. Morimoto and Hope, p. 212.

17. As of this writing, the Governor of Massachusetts has closed the "Big Dig" tunnels due to poor construction, which resulted in the death of a 38-year-old woman. Since opening in the early 1990s, the Euro-Tunnel has carried only 38 and 24 percent of anticipated passenger and rail traffic, respectively. See the website http://en.wikipedia.org/wiki/Chunnel#Construction.

18. YUM's Annual Report lists over 1,900 KFC restaurants in China versus slightly more than 700 for McDonalds.

19. According to data from www.Economist.com, accessed on 13 August 2006.

20. In 2005, YUM's KFC U.S. sales were $1.4 billion, while its China sales were $1.0 billion (YUM Brand Annual Report), and the firm opened 400 new restaurants.

Bibliography

China Three Gorges Project official web site: http://www.ctgpc.com/index.php.

Eckstein, Alexander. *China's Economic Revolution*. Cambridge: Cambridge University Press, 1977.

Gordon, Roger H., and Wei Li. "Taxation and Economic Growth in China." East Asian Bureau of Economic Research, Development Economics Working Paper #187. May 2002.

Granick, David. *Job Rights in the Soviet Union: Their Consequences*. Cambridge: Cambridge University Press, 1987.

International Rivers Network: Three Gorges: http://www.irn.org/programs/threeg/.

McGuire, Martin, and Mancur Olson. "The Economics of Autocracy and Majority Rule: The Invisible Hand and the Use of Force." *Journal of Economic Literature* 34 (March 1996): 72–96.

Morimoto, Risako, and Chris Hope. "Applying a Cost-Benefit Analysis Model to the Three Gorges Project in China." *Impact Assessment and Project Appraisal* 22, no. 3 (September 2004).

Naughton, Barry. *Growing Out of the Plan*. Cambridge: Cambridge University Press, 1995.

United Nations Economic and Social Commission for Asia and the Pacific. Available online at http://www.unescap.org/drpad/publication/integra/modalities/china/4ch04a.htm.

Weitzman, Martin, and Chenggang Xu. "Township Village Enterprises as a Vaguely Defined Cooperative." *Journal of Comparative Economics* 18 (1994): 121–145.

YUM Brands Annual Report 2005. Available online at http://yahoo.ar.wilink.com/asp/.