it has in recent years, or China's macro performance will deteriorate. This macro-micro inconsistency is unlikely to last forever.

Second, this inconsistency is present only in the more recent GCI rankings. In the earlier versions of the GCI, China outranked India on both the macroeconomic and microeconomic rankings. In 1998, in terms of BCI, China was ranked at 42nd place compared with 44th for India. (This fact answers the skeptical view that the ranking differentials are due to the ways that the indicators are compiled.) Since 1998, India has steadily and quietly improved its microeconomic fundamentals. The effect of these improvements does not show up instantaneously but these improvements will position India well down the road. That India overtook China in microeconomic rankings also debunks the widespread idea that India is now ahead of China in certain areas because India has a longer history of capitalism. This view completely ignores the fact that for 30 years, until the reforms in the early 1990s, India had a highly organized central planning system modeled after that in the former Soviet Union. The fact is that China led India substantially in economic reforms in the 1980s and most likely in the first half of the 1990s as well. India has now overtaken China in microeconomic rankings because China failed to make meaningful reforms in the 1990s.

3 Capitalism with Chinese Characteristics

> The economy is still the base; if we didn't have that economic base, the farmers would have risen in rebellion after only ten days of student protests – never mind a whole month. But as it is, the villages are stable all over the country, and the workers are basically stable too.
>
> – Deng Xiaoping on May 19, 1989[44]

This quote is putatively from Deng Xiaoping, who made the comment at the height of Tiananmen turmoil – May 19, 1989, the day the Chinese government declared martial law. As usual, Deng had the most incisive observation of the country. After the collapse of the Soviet Union, many came to the view that China was spared the same fate in 1989 because it did not liberalize its political system. The real reason why China did not collapse in 1989 was that its rural population was reasonably content in the 1980s.

One of the most damaging effects of the policy model of the 1990s is that it undermined the rural stability. Much of the increase in the political and social instability in the 1990s – documented before in the form of rising protests – occurred in rural China. Rising illiteracy will lead to rising crimes. (In a Yunnan prison, 65 percent of the prison inmates were illiterate

and 70 percent of them were rural residents.[45] The two populations likely overlapped substantially with each other.) The root of Chinese stability is its rural stability. The anti-rural bias of the policy model also entails significant economic implications: It slows down the pace and it alters the nature of China's transition to capitalism.

In this section, let me return to a broad theme of this book – assessing the nature of capitalism with Chinese characteristics. The consensus view among leading Western China economists is that China today is largely a market economy. Yingyi Qian (2003) remarks, "In the last 22 years of the 20th century, China transformed itself from a poor, centrally planned economy to a lower-middle-income, emerging market economy." Barry Naughton echoes this view. Writing in 2007, he states, "Today, many of the initial challenges of market transition have been overcome. The market is now the predominant economic institution in China" (Naughton 2007, p. 5).

Some of the prominent economists based in China, as compared with Western academics, have a far less sanguine view on the state of reforms.[46] Wu Jinglian, probably China's best-known economist, has forcefully argued that without genuine political reforms, China faces a real risk of falling into the trap of crony capitalism. Fan Gang, another well-known economist who sits on the monetary advisory committee of the Chinese central bank, has expressed similar concerns. The data and facts presented in this book are consistent with the views of these academics based in China. In this section, I place the state and evolution of capitalism in China against a broader, comparative perspective. First, I try to answer the question, "What is the best way to characterize the Chinese economy today?" My own characterization is that this is a commanding-heights economy, similar to that of many of the developing economies of 1970s vintage. Is this progress? Yes, in the sense that China has moved from a Leninist to a Nehruian system, but it is a far cry from claiming that the Chinese economy today is based on private-sector dynamism and a market orientation.

I then show that capitalism with Chinese characteristics is fundamentally different from capitalism with East Asian characteristics. The main difference has to do with the role and the size of the private sector. Another difference is the degree to which the state is a grabbing or a helping hand. The East Asian state, even the authoritarian state in Korea or that in Taiwan during the period of their respective economic takeoffs, was by and large benevolent. Corruption existed but the size of the corruption was not endemic. Social performance was excellent and it improved over time. I contrast these aspects of China with those of East Asia.

3.1 Commanding Heights

It was China, after 1978 under the influence of Deng, that accelerated leaving India far behind. . . . China did this paradoxically by adopting a much more "capitalist road." While India went on restricting its large native capitalist class after independence, China had to practically reinvent its own bourgeoisie after 1978.

– Meghnad Desai, a former professor at London School of Economics and a member of the British House of Lords (Desai 2003).

It is a remarkable view that China is more capitalistic than India, the world's largest democracy and a country with a continuous history of capitalism. Professor Desai is by no means among the minority of scholars to make this claim.[47] Similar comparisons are frequently made in the business media, claiming that China is a more vibrant, more capitalistic economy than India. Let us confront these views with some data.

According to the OECD study cited in Chapter 1, the Chinese private sector – covering both agriculture and industry – accounted for 70 percent of GDP as of 2003. I explained why this figure is a substantial overstatement of the Chinese private sector: The estimate includes the output by those legal-person shareholding firms that are still substantially owned by the state. Let me add another reason here. The assumption that agriculture in China is completely private is increasingly questionable in light of a development since the late 1990s – the massive land grabs that have rendered land leaseholds insecure.

For the sake of argument, let me ignore these computational complications and take the OECD's claim of 70 percent at its face value. Clearly, by the OECD estimate, China has moved substantially away from the centrally planned economy of the 1970s. But, we need to have an appropriate perspective here. For sure, 70 percent is high by the standard of centrally planned economies, but it is not at all high by the standard of capitalist economies, even some of the most statist capitalist economies. To illustrate this point, let us go back to the 1970s. This was a decade at the apex of the commanding-heights ideology. Among developing capitalist and statist economies, many far exceeded 70 percent of GDP in the private sector. Take Tanzania as an example. Under the radical leadership of President Julius Nyerere, Tanzania adopted a socialist economic model and yet, in 1978, the private share of its GDP was nearly 90 percent. In Brazil, the private share of GDP was 94 percent; in Venezuela, 73.9 percent (World Bank 1995, pp. 300–302).

What about Professor Desai's assertion that China is more capitalistic than India? For the sake of the argument, I again take at face value the OECD claim that the Chinese private sector, inclusive of foreign firms, was

producing 52.3 percent of industrial production in 2003 and 71.2 percent in 2005. I set a low bar for China – comparing China of the 2000s with India of the 1970s at the height of its economic statism. India at that time was at the apex of its commanding heights after Indira Gandhi nationalized all major banks, significantly expanded the scope of "License Raj," and created numerous barriers for the private sector. But, even at the height of the "License Raj," the importance of the Indian private sector was comparable to the level of the Chinese private sector in 2005. One estimate puts the share of private-sector firms in total manufacturing GDP in India at 93 percent in the early 1960s and at 69 percent in 1983–1984. The share of fixed-asset investments of the private sector was around 58 percent,[48] a ratio that is substantially higher than the broadest definition of the Chinese private sector as reported in Chapter 1: 33.5 percent in 2005 (and only 17.2 percent as recently as 1998). Thus, even a generous accounting of the current size of the Chinese private sector puts China roughly in the same league as one of the world's most statist economies of the 1970s. (It should be stressed that the OECD's estimate of China's private sector is inclusive of foreign firms, so this comparison is not affected by differences in FDI policies.)

One specific component of Professor Desai's comparison between China and India is especially off the mark. He argues that India restricted its "native capitalist class," whereas Deng's China encouraged it. China in the 1980s did encourage its "native capitalist class" (mainly in the rural areas), but in the 1990s, it went in a different direction. If we compare China of the 1990s with India, Professor Desai got the facts backward. The government of Indira Gandhi severely restricted the activities of multinational corporations (MNCs) in order to protect domestic businesses. Many firms, such as IBM and Coca Cola, left the country altogether.[49] Recall the finding in Chapter 1 that the size of the Chinese indigenous private sector relative to the foreign private sector is very small and the findings in Chapter 4 and earlier in this chapter that Shanghai and Jiangsu systematically restricted indigenous private entrepreneurship while eagerly courting FDI. My point here is not to suggest that India of the Indira Gandhi era pursued the right economic policies; there is plenty to suggest that her policies were hugely counterproductive. Rather, the point is that there is no evidence whatsoever that China since the early 1990s has been a more nurturing environment for indigenous capitalism than India.

3.2 How East Asian Is China?

Baumol, Litan, and Schramm (2007) classify China as an example of state-guided capitalism, similar to that in Japan and Korea. We can debate about

the accuracy of this empirical classification. In the 1980s, as the present book shows, China moved quite far toward entrepreneurial capitalism in its countryside. Urban China remained state-controlled but, because the vast majority of the population was rural then (and now), the entrepreneurial capitalism in the rural areas had a disproportional effect on the economy and brought about broad-based economic success.

The issue is whether Chinese capitalism today is closer to that in East Asia or that in Latin America. (Here, East Asia refers to Japan, South Korea, and Taiwan.) Regardless of one's views on the wisdom of the industrial policy approach of the South Korean government during that country's economic takeoff, the microeconomic foundation of that country was completely private. Most of the corporate entities in the Korean economy, such as Hyundai, Samsung, Kia, and LG, were privately owned. The entire banking sector was privatized in 1982. According to one estimate, in 1990, bank claims on official entities – including local governments, government investment institutions, and SOEs – were only 4.5 percent the size of the claims on the private sector (Haggard and Huang 2008).

Taiwan is another private-sector success story. According to Kuo, Ranis, and Fei (1981, pp. 80–81), 24 percent of loans were going to private enterprises in 1953 and this figure increased to 77 percent in 1979.

Let us take a look at China. We have fairly detailed loan data by ownership for short-term loans. (Long-term loans to the private sector are most likely even smaller.) In 2002, the percentage of short-term loans to the private sector – defined here as all TVEs and agricultural and private-sector businesses – was 19 percent (People's Bank of China 2003). This is nowhere near the level in Taiwan in 1979, but it is close to that during the statist era of Taiwan in 1953. Other analysts identify China with East Asia in terms of performance. They point to the fast GDP growth, rising export competitiveness, and rapid industrialization as common features in both China and East Asia.[50] Since the late 1990s, China has been investing a rising portion of its GDP – almost half in 2005. China economists have rationalized that this is similar to investments of other East Asian countries.[51]

The claim that China's investment/GDP ratio is comparable to that in East Asia in the 1970s is not accurate.[52] The investment/GDP ratio in China increased substantially in the 1990s, from the 35 percent range in the 1980s to the 40 to 45 percent range in the 2000s. China seems to have acquired a permanent addiction to investments. In 2005, the country invested 48 percent of its GDP in new fixed assets; in 2006, it invested 52 percent (NBS 2007a, pp. 26–27).[53] At 35 percent, China in the 1980s was quite close to that in Japan – around 33 percent in the 1970s – and within striking distance of Taiwan (around 26 percent). In the 45 to 52 percent range, China is in

an entirely different league. Korea had the highest investment/GDP ratio in East Asia. The height was 40 percent in 1990, but this was a one-off event. In the 1970s and 1980s, the ratio was within the normal East Asian range of around 30 percent.

The second difference with East Asia is the ownership composition of the investments. In East Asia, an overwhelming portion of investments took place in the private sector. In China, the opposite is the case. Take Korea as an example. It is true that the investment/GDP ratio rose from an annual average of 19.3 percent in the 1970s to about 32.3 percent in the second half of the 1980s, but the private sector led the way in this investment surge. On average, private-sector investments accounted for more than 70 percent of total investments in the 1970s and this ratio rose to more than 80 percent in the 1980s. So Korea started out in the 1970s with a higher level of private-sector investments and, over time, the private-sector investments grew even larger. China, on the other hand, started out with a weaker private sector in the early 1980s, when its share was only around 20 percent as shown in Chapter 1, and ended up even weaker in the 1990s. This is not an East Asian story at all.

The strength of the indigenous private sector is really the essence of the East Asian model. According to Campos and Root (1996), East Asia did not invest at an inordinately high level as compared with Latin America. What distinguished the higher-performing East Asian economies was the high proportion of private investments. The high state share of investments puts China closer to Latin America than to East Asia. There is another East Asian difference with China. Except for Singapore, FDI played an insignificant role in the extremely successful export production of the East Asian economies. In the mid-1970s, FIEs in Taiwan accounted for only 20 percent of Taiwan's manufactured exports.[54] In China today, the ratio is more than 60 percent.

Students of East Asia all agree that the state was interventionist during the growth period (Wade 1990), but the state interventions were ultimately market conforming.[55] Consider the famous example of Formosa Plastics. The government on Taiwan established the firm but it did not intend to run it. Instead, the government recruited Wang Yongching, a businessman who was not even living in Taiwan at the time, to run the firm. Wang subsequently built Formosa Plastics into the world's largest PVC producer. Li Kuoting, the father of Taiwan's economic miracle, constantly exhorted his government colleagues to look at "things from the entrepreneur's point of view."[56]

Contrast this with China's top-down approach. In the 1990s, China strongly promoted a number of industrial policies but the Chinese industrial policy initiatives drew almost no input from the business community,

not even from the SOEs. According to a 1998 survey, only 4.5 percent of respondents believed that enterprises and enterprise associations played a key role in industrial policy making; 65 percent of the respondents said that only the central government was responsible. When asked if the government's market forecast was correct, more than half of the respondents answered in the negative (Zhao 1998).

There are sharp differences in the area of social performance between China and East Asia. Here, it is important to have a precise idea of what the "East Asian miracle" means. The East Asian miracle does not only refer to the fact that East Asia grew rapidly; during its period of growth, East Asia also had excellent social performance. In East Asia, the Gini coefficient was low at the start of the economic takeoff and remained low during the takeoff. In Korea, the Gini increased modestly from 34 in the mid-1960s to 36 in the early 1980s. In the case of Taiwan, the Gini actually declined from 36 to 31 during the same period.[57] China, as documented previously, has experienced a sharp rise in the Gini. This is not a story of "rapid growth with equity."

3.3 The Grabbing Hand of the State

Historically, some of the capitalist countries used all sorts of means to squeeze out the peasants, forcing them to enter into bankruptcies and to become a source of cheap labor. . . .

– Wan Li (1992 <1982>, p. 145), vice premier of China, 1984–1988

The poorest man may in his cottage bid defiance to all the force of the Crown. It may be frail; its roof may shake; the wind may blow through it; the storms may enter, the rain may enter – but the King of England cannot enter; all his forces dare not cross the threshold of the ruined tenement!

– William Pitt, Prime Minister of Britain, 1766–1768

The authoritarian states of East Asia, by and large, were benevolent. Park Chung-Hee, the leader who created Korea's economic miracle, exemplifies this combination of supreme power and deliberate self-constraint. Although ruling with the iron fist of a military general, Park was methodical and conscientious in his economic management. ("There was a method to his madness," as political scientist Meredith Woo grudgingly admired.) Never a man of political patronage, he ruthlessly held his subordinates accountable to his high and strict meritocratic ways. On the eve of each New Year, he would visit his cabinet ministers to discuss goals and strategies for the upcoming year and followed up with a performance check one year later. Those who failed more than 80 percent of the targets were fired on the spot

(Campos and Root 1996, p. 140). He scrupulously avoided creating perceptions of bias and cultivated policy credibility. He made a practice of meeting with businesspeople only in large groups in which the businesspeople acted as representatives of their industries rather than as representatives of their firms (Johnson 1987).

The East Asian states invested heavily in education and public health and expanded the social opportunities for their citizens. Corruption existed in East Asia but was unlikely to approach the pervasiveness of China today. Land grabs, currently an endemic problem in China, were unheard of in East Asia. It is widely acknowledged that land reforms, which solidified the private ownership of farmers, laid the foundation of the East Asian economic miracle. For whatever reasons, the East Asian states governed in ways that maximized the public interest.

By contrast, the Chinese political system became increasingly self-serving in the 1990s. A blatant illustration is how it enriched itself at the expense of the society at large. Between 1989 and 2001, the Chinese government increased the salaries of its civil servants five times – and four times between 1998 and 2001 – and each time by a double-digit rate.[58] As a result, civil servants today are among the best paid and the most desired professions in China. In a 2007 survey, college students in Beijing ranked a government job as the second most desirable, after a job in a MNC. (In the same survey, 13 percent wanted to work for SOEs and only 1 percent wanted to work for the domestic private sector.)

An official rationale for increasing the salaries of civil servants was to counteract the recessionary effect of the Asian financial crisis by boosting internal consumption. (Another rationale – i.e., to reduce bureaucratic incentives to accept bribes – was patently false given that the amount of bribes in the 1990s amounted to millions of yuan.) But the same bureaucracy repeatedly reduced the incomes of those with the highest propensity to consume – China's rural poor. Between 1997 and 2002, the Chinese state *lowered* the official rural poverty line – which entitled the poorest people to very basic assistance – three times, matching perfectly in timing with the four salary raises for civil servants. In 1997, the rural poverty line was stipulated at 640 yuan per person. This was reduced to 635 yuan in 1998 and 625 yuan in 1999. In 2001, it was raised to 630 yuan, only to be reduced again to 627 yuan in 2002. As in other areas, the poverty line was adjusted upward under the leadership of Hu Jintao. In 2003, it was 637 yuan and in 2006, it reached 693 yuan.[59] The aforementioned figures are nominal; after adjusting for inflation, the official poverty line has never exceeded the level established in 1987.

The Chinese state today – especially at the local level – is dangerously proximate to "a grabbing hand," a term coined by Frye and Shleifer (1997) to describe the Russian state of the 1990s. Exercise of power for pecuniary interest and corruption were hallmarks of Russia's distorted transition to oligarchic capitalism. In the Chinese context, the state *literally* grabs – for land. At the beginning of this section, I quote from Wan Li, the vice premier in charge of agriculture in the 1980s and a liberal reformer who launched the rural reforms in poor Anhui province. He was warning against what he believed to be a widespread practice in capitalist countries – the massive taking of land from the peasants that drove them to become a source of cheap labor. He might have worried too much about the capitalist countries. The quote from William Pitt, the prime minister of Britain during the primitive stage of that country's capitalist development, shows that property rights were more secure than credited by Wan Li.

With remarkable prescience, Vice Premier Wan was right on target in his 1982 comment, not about the capitalist countries but rather about China since the late 1990s. In Chapter 3, we saw that the per-day earnings in local non-farm activities dropped sharply in the 1990s (although the migrant per-day earnings increased). Many urban businesses refused to honor their wage contracts and they accumulated massive wage arrears to migrant workers. The situation became so egregious that the Chinese premier personally intervened to resolve several cases of late wage payments. A Chinese reporter, quoting from the All-China Federation of Trade Unions, reveals that the cumulative wage arrears at the end of 2003 stood at 100 billion yuan.[60] China has even resurrected slave labor. One infamous case, exposed in 2007, involved 570 slave laborers forced to work eighteen hours a day and seven days a week in a kiln in Shanxi province.

Macro data also show that the labor share of GDP declined throughout the 1990s. According to Li Daokui, an economist at Tsinghua University, the labor share of GDP declined from 53 percent in 1990 to 48 percent in 2005. Li points out that China has one of the lowest labor shares of GDP in the world. Most countries vary between the 60 and 80 percent range.[61] Land grabs may have contributed to this adverse development for the Chinese working class. The first effect of land grabs was the uprooting of a large number of farmers. These farmers then flooded the labor market and further reduced the bargaining power of labor in a populous country struggling to create employment opportunities. Taxing rural China heavily – by charging school fees – was another factor. One effect of failings in rural basic education has been the early release of young people onto China's labor market. We can view the 30 million newly illiterate Chinese as 30 million

additional members of the workforce. The labor supply increased due to these dynamics.

The most systematic evidence for the scale of the land grabs comes from a joint research project between researchers at the Chinese People's University and Michigan State University.[62] They report that nationwide land grabs have increased 15-fold over the past decade. According to their survey, covering nearly 2,000 rural households scattered in 17 provinces, 83 percent of which comprised the rural population, 27 percent of the rural households either experienced or witnessed one or more incidents of government land-taking since the late 1990s. If their survey remotely captures the reality of rural China, the number of people and the degree of livelihood affected by the land grabs are on a truly phenomenal scale.

The land grabs may explain several phenomena documented in this book. In Chapter 3, we saw that although the aggregate rural income rose since 2002, the non-farm business income stagnated. In Chapter 1, we saw that private rural fixed-asset investments failed to grow despite a more pro-rural and liberal policy environment under Hu Jintao and Wen Jiabao. It is quite possible that the land grabs have undermined the security of property rights so much so that rural private entrepreneurs have stopped investing.

The land grabs are not only a rural affair. Forced evictions of long-term residents to make way for new development projects have occurred in numerous cities, including Beijing, Shanghai, and Guangzhou.[63] These evictions – as well as the land grabs in the rural areas – have often taken place with the full connivance of local governments and despite the repeated prohibitions issued by the central leadership of Hu Jintao and Wen Jiabao. The most likely reason for the land grabs in the rural areas and forced evictions in the urban areas is corruption. Politically connected developers bribe government officials to acquire sweetheart deals on the one hand and to lean upon the coercive power of the state on the other – as the entrepreneur who gained the management rights to the new Xiushui Market did – to enforce the eviction orders.

Corruption is not new in China, but the general consensus is that corruption intensified massively in the 1990s. The extent of the scale of corruption is illustrated by the amount of the bribes involving the highest levels in the Chinese political system. According to a study of all the reported bribery cases involving government officials at or above the rank of minister or provincial governor from 1986 to 2003, in the 1980s, the highest amount of a bribe was 16,000 yuan paid to a vice governor of Xinjiang province (Sun 2004, pp. 46–49). This compares with the highest bribe between 1990 and 2003 of 40 million yuan. The second highest was 25 million yuan and

the third highest was 18 million yuan. The lowest amount of a bribe in the 1990s was 64,000 yuan, an offense committed in 1994. In nominal terms, the lowest amount of a bribe in the 1990s is four times the highest amount of a bribe uncovered in the 1980s and 2.3 times in real terms. Corruption in the 1980s can be described as individual cases of malfeasance; in the 1990s, it has intensified to a systemic proportion.

There is an entirely different style of corruption in China now. Pei (2006, p. 21) notes that corrupt officials in China have become younger. Of those officials caught for corruption in the province of Henan, 43 percent were between the ages of 40 and 50. One would normally think that officials in the prime of their careers would be more circumspect. Corruption today takes the form of grand theft and insider looting, not just under-the-table deals. Liu Jinbao, an executive at the Bank of China's branch in Hong Kong, stole 41 million yuan from the bank. In another case, managers at the Bank of China branch in Kaiping in Guangdong province stole US$483 million from 1997 to 2002 (Pei 2006, p. 118). Furthermore, corruption is no longer the exclusive domain of politicians and SOE managers. In a semi-official 2006 blue book on education, the authors devote two chapters to "unhealthy practices" and "corruption" in the field of education (Yang Dongping 2006).

4 China's Prospects

> We had been in the largest boom in Mexican history. And for the first time in our history, in those years 1978 through 1982, we were being courted by the most important people in the world. We thought we were rich.
>
> – Silva Herzog, finance minister of Mexico, reflecting on the period leading to the debt crisis of 1982[64]

This quote from the Mexican finance minister in the 1970s reminds us of the era when countries such as Mexico and Brazil were viewed as economic miracles. They were the darlings of foreign investors and their GDP growth was extraordinarily rapid. But, over time, their growth began to stagnate. The entire decade of the 1980s was lost for Latin America and in the 1990s, after a brief period of surging growth and rising FDI, the Latin American region slowed down again. Many of the countries in the region are plagued by poor social and microeconomic fundamentals. If there is one lesson from the experience of Latin America for China, it is that FDI is neither the necessary nor the sufficient guarantee for economic prosperity.

China today is a darling of foreign investors, but it should heed another lesson from Latin America as well: The sentiments of foreign investors are poor predictors of long-run economic prosperity. In the final section of this