THE FALSE PROMISE OF 'MARKET SOCIALISM' IN CHINA

Despite the hype, China is not evolving into a 'successful dictatorship' writes **John Lee**

Are we witnessing the evolution of a new market based phenomena—the world's first truly 'successful dictatorship' overseeing a robust market economy—on a historical scale? The economic rise of China, a country that has enjoyed growth rates of around 10% per annum over three decades, offers perhaps the most compelling illustration of how to manage the transition towards a free market and indeed how one should 'do' capitalism. One might even say that China presents a new paradigm. It has instituted a series of gradual and ad hoc reforms without democratisation, and does not plan political liberalisation in the future. The Chinese Communist Party (CCP) might not control every aspect of social and economic life, but it tries to oversee it all and retains power exclusively for itself.

Not long ago, the state retaining monopolistic control over key sectors of the economy would have seemed a recipe for disaster, especially for a communist state seeking the cure of market reform. But today in China it seems to be working. The apparent success of the Chinese experiment—called 'market socialism' or 'Leninist corporatism' by some in the West—challenges conventional wisdom about the political and social conditions required for the successful operation of free markets. In 2004, former World Editor of *Time* magazine Joshua Ramo authored a paper arguing that China had become an alternative and successful model for developing countries and that this model 'offered hope to the world'.[1]

By implication, European and Anglo models—praiseworthy as they are—are relevant only for the developed West. *Der Speigel* felt compelled to ask in a major article: 'Does communism work after all?'[2] Even prominent *New York Times* columnist Thomas Friedman has admitted that he has 'cast an envious eye on the authoritarian Chinese political system, where leaders can, and do, just order that problems be solved.'[3] As Kevin Hassett from the American Enterprise Institute concluded recently, 'being unfree may be an economic advantage.' He continues, 'Dictatorships are not hamstrung by the preferences of voters' for policies that might impede economic growth.[4] The fascination is not just economic—China is creating a huge ideational splash.

To be sure, capitalism is not a single model system. Variants emerge and models *evolve*. Does China's example offer the 'latest thinking', the new international 'best practice', for the successful evolution and implementation of market based systems? Contrary to the fascination and hype, I argue that China's 'market socialism' is a dangerous perversion of a capitalist system; that the current model is failing and unsustainable.

John Lee is a Visiting Fellow at The Centre for Independent Studies and Managing Director of L21, a research and conference organisation. His book, *Will China Fail?*, from which this article is drawn, will be published by CIS in 2007.

Capitalist systems as evolving systems

Why is it useful to talk about capitalism as an 'evolutionary' system? Static conceptualisations of any system are plagued by severe limitations. Static models emphasising a stable set of given assumptions do not describe reality adequately because reality is not static; learning and information gathering is an essential part of living systems. Fifty years ago, Friedrich Hayek put forward his conceptualisation of a robust economic system as one that encourages the growth and sharing of *knowledge* within that system. It is arguably his single most important contribution to liberal economic thought. To understand why this remains such an important insight, consider the problem that Hayek believes we hope to solve when we construct an economic system.

For evolution to do its work, *selection* mechanisms to test new solutions for existing problems must arise.

In Hayek's article, 'The Use of Knowledge in Society', he argues that *if* a mastermind in society possesses *complete* knowledge about what we need and want, the means (both labour and capital) at our disposal, and how best to utilise these means, then the answer with respect to how we should use these means to achieve these ends could be logically and comprehensively derived.

However, this is clearly *not* a reflection of reality; *not* a reflection of the economic conundrum that societies actually face. As Hayek observes:

> The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.[5]

So knowledge is dispersed and piecemeal. For example, the local butcher is in a much better position to know what the demand for sausages in his/her area might be. Hence, this butcher is much better placed to know the quantities of raw ingredients he/she needs to buy to make an appropriate number of sausages each week. In turn, the butcher knows better than anyone else what proportion of spending should be devoted to sausage meat compared to other products, and so on. These small bits of knowledge might be obvious to the butcher but are far from obvious to anyone else. In other words, it is impossible for a mastermind to exist in society since knowledge about needs/wants and the means required to attain them are dispersed and also constantly changing. Any such person or body (whether it is a government, bureaucracy and so on) behaving like a mastermind is afflicted with what Hayek termed a 'fatal conceit'.

Viewing a free market as an 'evolutionary' system that promotes the growth of knowledge might not explain everything about why capitalism has been more successful than alternatives but it explains a lot. When we consider the enormous complexity of a modern economy, the possibility that there can be an effective mastermind becomes even more remote.

In an article on evolutionary economics published in *Policy*, Jason Potts looked at the liberal economic tradition and some of the thoughts of liberal economists such as Hayek.[6] Economic evolution is about how knowledge grows. As Potts explained, some ideas (including mechanisms and processes) are tested and found reliable or useful, and others are similarly tested and rejected. For evolution to do its work, *selection* mechanisms to test new solutions for existing problems must arise. The worse solutions are eliminated and the better ones are *replicated*. In turn, *variations* of these better solutions offer new approaches. Indeed, this is the essential function of free and open markets: to serve as a mechanism that structures the process of knowledge growth. And it is also the reason for the success and capacity of these structures to adapt. The wider and more organised the market, the greater the possibilities for learning, specialisation and adaptation. As Potts argues, it is the growth of knowledge—this evolutionary process—that ultimately underpins the wealth of nations. It is market capitalism that most closely embodies the mechanisms of this evolutionary process.

Tailoring capitalism: different societies, different versions

Although Potts was largely speaking about the process of change *within* an existing capitalist system, it is useful to extend the analogy to look at the development of different *versions* of capitalism—the evolution of different models. Systems can be tailored to fit the political and social circumstances of different societies. This is why it is perfectly legitimate to have different models of capitalism. Successful transitions to free-market systems depend upon new adaptations to meet the particular problems faced by different societies. However, this does not mean that every variation should be praised in the name of experimentation and learning. Some variations will ultimately prove to be successful illustrations of capitalist evolution. Others will not.

In terms of China, the most common presumption is that 'capitalism with Chinese characteristics' is working. China began the reform period in 1978 with a set of challenges that Western societies are no longer familiar with, namely an undeveloped economy with a primarily rural population and a backward industrial sector. There were enormous social challenges as a result of its recent history—for example, the Cultural Revolution—in which order and stability had to be the greatest priority. Any Western 'Big Bang' approach of rapid political and economic liberalisation was simply not appropriate. China had to find its own way forward and experiment with its own version of market economics. And in doing so, say the Chinese leaders, China is moving toward a capitalist system that meets the economic, but also the social and political challenges of Chinese society. This, in the eyes of many, is a powerful illustration of successful experimentation—an argument persuasively backed by its double digit growth rates over thirty years.

Chinese capitalism: success story or perversion?

In looking behind the impressive growth rates, I argue that the evidence that the Chinese economic model is a *perversion* of a capitalist one, as opposed to a successful evolution of one, is strong. China's profound problems largely stem from the Party's predatory attempts to extract the fruits of a partial free market in order to remain in power—the explicit reason given for reform in the first place. As Potts and other liberal economists have argued, market capitalism produces growth because it is a set of institutions that fosters the growth of individual and local knowledge. Efficient allocation of resources and exchange of property rights must go hand in hand with, and feed, this growth and spread of knowledge. In the Party's determination to hold on to power, the transformative effects of a capitalist economy are being significantly held back.

Although China is frequently characterised as a free market economy, the state retains a significant role. For example, well over half of China's fixed assets are owned by the state. The raw number of state-owned enterprises (SOEs) might be shrinking but the SOEs receive about 70% of the country's capital to invest, even though they only produce about 30% of the output. This has been the trend for over a decade. The state has identified about a dozen key sectors of the economy including banking, construction, and telecommunications, and retains effective control and command over them.

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This is not a problem in itself. The CCP has followed a policy of 'gradualism' to balance the need for social stability against economic reform. Many also argue, with some merit, that this is a prudent strategy considering the Russian experience in which there was an immediate loss of output following the dismantling of SOEs in the rush to privatise. The plan was to foster the development of a significant non-state sector alongside the state-owned one. This has undoubtedly been achieved. Moreover, it was mooted that the gradual decentralisation of decision making would move from the rural provinces, to the cities, and finally to SOEs and other public bodies. Once local authorities and individuals became more practiced at making decisions for themselves, market initiative and enterprise would take hold and eventually flourish.

Indeed, the seeds of genuine market capitalism in China have been planted and in many respects have sprouted. One of the earliest examples took place at the beginning of the reform period when large state-owned collectives gave way to the household responsibility system. Farmland, although still owned by the state, was reallocated to individual households through fixed length contracts. After fulfilling procurement quotas, farmers were allowed to sell surplus crops to an open market—usually country fairs. This obviously improved the incentive structure of agricultural production. It was also a powerful demonstration of the benefits of allowing a system in which the utilisation of individual knowledge was allowed to guide labour and resource allocation. Farmers were given greater autonomy in production decisions and increasingly allocated resources to more profitable and in-demand activities such as orchards, fisheries and animal husbandry. From 1978–1995, total factor productivity in agriculture almost doubled. As farmers attained greater wealth and control over this wealth, they experimented with non-farm enterprises. The resulting Township and Village Enterprises (TVEs) employed about 135 million people in 1995 compared to about 30 million in 1979.

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These early experiences proved that individual and entrepreneurial activity could successfully take root in China despite the decades of turmoil and socialist experimentation. A noted Chinese expert, Kate Zhou, characterised the developments as a 'spontaneous, unorganised, leaderless, non-ideological, apolitical movement.'[7] Even Deng admitted, 'The result was not anything I or any other of the other comrades had foreseen. It just came out of the blue.'[8]

Since then, private enterprise has taken root. It accounted for about 2% of total output in 1979. It is now about 70%. Optimists believe that the evolution of a successful free market system in China is on track—'gradualism' seems to be working.

Yet, despite China's growth rates, its social deficits indicate that something is profoundly wrong. For example, 80% of the Chinese that emerged out of poverty since 1978 did so in the first decade of reform, not more recently as many assume. Independent studies suggest that unemployment and gross underemployment is about 10–20% in urban areas and 25–40% in rural areas.[9] Reported significant instances of social unrest have grown from a few thousand in the early 1990s to 87,000 instances in 2005, the latest available figures.[10] A Hong Kong based study believed that the figure in 2003 was closer to 300,000.[11] These are just a few of the problems that the Chinese government are reluctant to speak about.

Sound market systems promote the growth and spread of knowledge; and resources and the movement of wealth and property must go hand in hand with an open system by being appropriately allocated. If so, where is the Chinese model going wrong and why?

Bad loans

The Chinese are famed for their level of savings. They save about 30–40% of their income, largely to provide for themselves in old age, and almost all of it is deposited into state-owned banks since there are few alternatives. China's economic treasure chest is built on the back of these savings. The financial assets of banks constitute about 98% of China's total financial assets. Four big state-owned banks alone control about 70% of these assets. Only about 2% of financial assets are held in private or foreign owned institutions.

Worryingly, all of China's main banks have been technically insolvent for over a decade, weighed down by non-performing loans (NPLs). In 2006, accounting firm Ernst & Young estimated total NPLs in the financial system at US$911 billion—about 40% of GDP. These banks are only able to operate due to periodic bail-outs by the government (in which bad loans are transferred to 'asset management companies') and access to continued liquidity only due to the high savings of the population in these banks. This problem has been deteriorating for a decade. Why is this?

According to a recent IMF study, 75% of China's growth comes from capital accumulation.[12] In other words, growth is largely the result of pouring money into investment projects. Fixed asset investment increased by over 25% in 2005. In the first half of 2006, it jumped a further 30%. Investment bank Morgan Stanley estimated that fixed asset investment probably exceeded US$1.3 trillion in 2006.[13] The state (through state-owned banks) directed over half of this and still owns about 56% of fixed capital stock. This would be an acceptable strategy provided that capital is used efficiently and productively. Unfortunately, this is not the case.

World Bank findings indicated that about one third of recent investments made were wasted.[14] In the 1980s and 1990s it took $2–$3 of new investment to produce $1 of additional growth. Studies from the last several years show that it now takes over $4 to produce $1 of additional growth. Recent Morgan Stanley and McKinsey & Co reports suggest that it was more like $5 invested for $1 of additional growth—which is worse than during the Mao era![15] In other words, Chinese investment is getting less and less bang for its buck. Why is it taking more and more money to achieve the same level of growth?

China is suffering the effects of massive and chronic 'overinvestment', over-capacity, and declining productivity. *The Economist* estimated that while nine out of ten manufactured goods were in oversupply in 2004, investment in fixed assets grew by 30% over the same period and contributed 47% of GDP.[16] In other words, increasingly large amounts of money are being poured into producing goods that are not consumed or needed by the economy. This is reflected in the slow moving inventory of Chinese firms, which are estimated to take around 350–360 days to sell, and in the levels of unsaleable inventory, which are possibly the highest in the world.[17] This is a symptom of overinvestment and produces growth figures that are bulked up by 'assets' that will never be used.

In light of these trends, we would expect investment growth to decline as rationalisation takes place. Instead, the opposite has happened. According to Peoples' Bank of China data, capital investment from 2000 to 2005 doubled. Bank investment loans increase by almost 10% in 2005. In the first six months of 2006, they increased by almost 10.5%.[18] More money is being invested even as returns are diminishing.

Politicised investment

Quite clearly, capital allocation (in the form of credit and 'subsidies') frequently has little to do with rational economic decision making. As mentioned, 70% of capital is reserved for SOEs. A conservatively estimated 40% of bank loans to SOEs are extended on a 'policy' rather than 'commercial' basis while most loans to SOEs are afforded artificially low interest rates.[19] An estimated two-thirds of NPLs were given on a 'policy' basis. Banks are effectively fulfilling the political priorities of the government through their 'policy lending' function: to maintain jobs for SOE workers who are the Party's most loyal supporters, to maintain support for SOE managers who are mainly Party members and supporters, and to maintain growth at any cost since the Party, despite the waste, has staked their credibility on it. All of this merely furthers the end of maintaining loyalty to the ruling Party and entrenching its power.

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Good economics is largely about the effective creation, use and distribution of wealth and services. The system set up and perpetuated by the regime is not one primarily for wealth creation. It is a system set up by and for a predatory regime determined to use the fruits of a partial market to perpetuate its rule no matter the economic cost. Moreover, in terms of creating an efficient, open system that precipitates the growth of knowledge and *uses* this knowledge to create wealth, critical institutions required to precipitate fair interaction and exchange are severely lacking.

Take the Shanghai stock market as one example. A stock market exchange should be a mechanism through which those individuals and companies who have specialised or have expert knowledge raise money from investors to fund a venture. It should also be a place where the value of companies is determined according to investor assessments. In China, stock markets are generally used to raise capital to keep SOEs afloat and increase the share price for firms with state backing (in which only about one third of shares are floated and the state retains majority ownership). It does not serve as an effective capital raising or valuation medium for enterprising private firms for which listing is restricted. In fact, only about 40 of the over 1500 listed firms are private.

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The Shanghai stock exchange is indicative of the cancer in China's system. Market systems expand and thrive when rational *selection* mechanisms are working: successful mechanisms and ventures thrive and are replicated, and failing ones are allowed to fail. This largely does not occur in China. Other successful Asian economies adopted market processes as a *transformative* strategy; China has adopted free markets as a *therapeutic* one to preserve the regime's hold on power. While other Asian economies encouraged and supported private enterprise and innovation, China is politically bound to direct the majority of its capital to prop up failing companies—most of which are led by Party officials and supporters. Although foreign companies (who receive an overwhelming proportion of foreign direct investment) thrive in China, protection in over two dozen key industries that SOEs operate in is primarily designed to prevent private domestic firms from challenging SOEs. Combined with the lack of access to capital for these private firms it is no wonder China cannot produce any world class private domestic firms in key sectors of its economy. This is a deficiency made more serious by the fact that growing China's private sector remains the only viable way of solving the country's unemployment problem.

The selection mechanisms that evolutionary economists speak about are retarded in China. The country's wealth follows politics, not merit. The fair and level playing field—essential for sound selection mechanisms and knowledge to spread—is corrupted by judicial, administrative and regulatory bodies that consist entirely of Party officials. 'Rule of the Party' largely supersedes 'rule of law'.

The question of property rights is indicative of the malignancy in China's system. In China, granting and *enforcing* widespread property rights would strip away the power of CCP officials who essentially rule through the extraction of collective rents and poorly compensated seizures. Yet, enforceable property rights are intrinsic to any free market. Constitutional laws passed in 2004 that deem property rights as 'inviolable' and reflected in the much-heralded property law passed in March 2007 do little to change the status quo. In commenting on these laws, *The Economist* observes:

> This latest law will not bring the full property-rights revolution China's development demands. Indeed, it will not meet the most crying need: to give peasants marketable ownership rights to the land they farm. If they could sell their land, tens of millions of underemployed farmers might find productive work. Those who stay on the farm could acquire bigger land holdings and use them more efficiently. Nor will the new law let peasants use their land as security on which they could borrow and invest to boost productivity. Nor, even now, will they be free from the threat of expropriation, another disincentive to investment. Much good land has already been grabbed, and the new law will merely protect the grabbers' gains ... Moreover, should an underdog try to use the new law to enforce his rights, the corrupt and pliant judiciary would usually ensure he was wasting his time.[20]

These problems have been worsening for over a decade. They are not just a temporary hitch, a speed bump along the way. With its traditional rural support base in tatters, resentment of urban populations growing, and new elites agreeing to be co-opted only while there is more money to be made, the leadership cannot change course and retain exclusive power. Instead, despite all public proclamations to the contrary, most initiatives are merely *tactical* moves to appease dissatisfaction and put out spot fires that arise. The party has to rely on increasingly desperate and burgeoning tactical redistribution policies to remain in power. Meanwhile, the economic and social deficits accumulate even if foreign companies and well-connected insiders, that is, Party officials or supporters, within China continue to make money.

Conclusion

Potts concluded in his *Policy* article that:

> If the goal is to grow the wealth of nations and societies, then this will invariably involve growing knowledge, and the best way to do this is to unleash evolutionary forces.[21]

The evolutionary forces of successful selection/replication/variation and also 'creative destruction' are being held back in China. Far from a 'successful dictatorship', we are witnessing an economically predatory one on an unprecedented scale. The fear is that authoritarian regimes do not easily let go—not until forced by catastrophe anyhow. No one can predict the future of the world's most populous nation. But hope for China should be founded on limiting the regime's role and reach and bringing it under the rule of law—not on the false promise of a new, alternative and retarded model of capitalism that has been too easily praised by too many.

Endnotes

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21 Potts, 'Evolutionary Economics', p 62.