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## The disinterested government: An interpretation of China's economic success in the reform era

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Research Paper No. 2009/33

## **The Disinterested Government**

An Interpretation of China's Economic Success  
in the Reform Era

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### **Abstract**

In the last 30 years, China has achieved high economic growth and successfully transformed its economy from a planned economy to a market-based system. The country, to a large extent, has attained success through the recommendations proposed by standard economic theory. However, the role of political economy has been omitted from the literature: how did China adopt the right economic policies and the appropriate road to reform? This paper attempts to answer this question. The central assumption of the paper is that China achieved success because the Chinese government has been a disinterested party, i.e., a government that does not favour any particular sections of the population and prioritizes the long-term welfare of the whole society. In this paper, we first define and analyse the concept of disinterested governments, and then proceed to provide several examples to demonstrate that China has been characterized by a disinterested government. Based on a theoretical model, we also discuss the reasons of the Chinese government becoming a disinterested government.

Keywords: disinterested governments, the China miracle, economic reform

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## Acronyms

CCP	Chinese Communist Party
FDI	foreign direct investment
NPC	National People's Congress
NPCC	National People's Consultative Conference
PRC	People's Republic of China
SOEs	state-owned enterprises
TVEs	township and village enterprises

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## 1 Introduction

Any unbiased observer would consider China's progress over the last 30 years a success. The country has maintained an average annual growth rate of 9.7 per cent and transformed its economy from a planned system to a market-based one. The Chinese society, defying repeated warnings of an imminent collapse, has remained relatively stable yet dynamic, and for the majority of the people, the last three decades constitute the best period of the last 130 years, or since the Imperial China lost its confrontation with the western powers in the Opium War. For example, the per capita GDP has increased from US\$250 at the end of the 1970s to US\$3,330 dollars (current prices) in 2008 and the number of people in absolute poverty has decreased from the early 1980s figure of 300 million to 80 million today (NBS 2009).

China's economic success, to a large extent, can be attributed to its almost relentless reform drive towards a free market economy. Although its reform path was rather unconventional, the ultimate policies and institutions in China have been clearly converging towards what standard economics advocates. If there are success stories to the Washington consensus, then China must be counted as one of them, and viewed from this perspective, there is nothing miraculous in its record growth (Perkins 2005). But this leaves an important question unanswered: if the economic theories were so right, why have not most of the developing countries followed them? Or, in other words, how has the People's Republic of China (PRC) been able to adopt the right recipes for growth? The explanation can be found only by examining the political economy of China's miraculous economic growth in the last thirty years.

Central to this paper is the argument that China's success lies in its disinterested government. A disinterested government is one that does not differentiate between the interests of different segments of society. Such a government is more likely to be what Olson (1982) calls an encompassing organization whose interests overlap with those of the whole society. That is, it is more likely to foster the country's overall economic growth instead of advancing the interests of the population segments it represents or has formed an alliance with.

We identify three major reasons why the Chinese government became a disinterested government in the reform era. The first reason is the lesson learned during period of 1949-78, when the Chinese Communist Party (CCP) modelled itself as a working-class party and emphasized class struggles in conjunction with economic construction. The results were dismal and led to a crisis regarding its legitimacy. Second, the Chinese society was unusually equal at the beginning of the reform period, thanks to the 1949 Communist Revolution and the egalitarian policies of the ensuing years, 1949-78. If society is equal, the government has no incentive to form alliances with any population sectors because these alliances will not be strong enough to offset attempts by the discontented to revolt. Third, the CCP made conscious adjustments to its own ideology and social affiliation, successfully transforming itself from a working-class party to an all people's party.

In the rest of the paper, we first examine (section 2) how China responded to the standard recommendations of the Washington consensus, as it was originally formulated by Williamson, and show that China has been following this advice for the last three decades. In section 3, we argue that the authoritarian nature of its government was not a key factor for China adopting the appropriate economic policies. In section 4, we

present our theory of disinterested governments, linking the concept to Mancur Olson's notion of encompassing organizations and then discussing their differences. We present evidence in section 5 to show that the Chinese government was indeed disinterested during the reform era, and in section 6, we analyse the three reasons that led to this outcome. We conclude by discussing the applicability of the Chinese experience to other developing countries in section 7.

## **2 A case for the Washington consensus**

Many authors, both within and outside China, believe that the country achieved economic success by deliberately defying certain recommendations of good economic policies advanced by standard economic theories, such as those of the Washington consensus. The Beijing consensus proposed by Joshua Ramo (2004) is but one example. However, these authors may have confused China's path of transition with its aim of transition. Undoubtedly, China adopted a unique path of reform, and in many cases the results did not comply with standard economic institutions. It is also admittedly true that China has not unconditionally followed the advice of international donors or other governments; it opened to the world, but on its own terms and at its own pace. The aim of China's transition, however, was clear: to establish a market economy.

In the original formulation (Williamson 1990), the Washington consensus emphasized the following key policy recommendations:

- Fiscal discipline;
- Reordering public expenditure priorities away from non-merit subsidies and toward public goods (e.g., health and education);
- Tax reform that combines broad tax base with moderate marginal rates;
- Liberalized interest rate;
- Trade liberalization;
- Liberalization of inward foreign direct investment;
- Privatization;
- Deregulation to ease barriers of firms for entry and exit of sectors; and
- Strong protection of property rights.

On balance, over the last three decades China has closely followed most of these recommendations, with the exception of interest rate liberalization. As a discussion of the reasons for this exception is beyond the scope of this paper, the rest of this section will focus on the achievements of China.

In terms of fiscal discipline, the government has been cautious to maintain a roughly balanced budget; debt has never surpassed tax revenue. Prudent fiscal policies have led to a stable economy, and over the last three decades, China has experienced three inflation waves (mid-1980s, mid-1990s, and mid-2000s), none of which were serious. The highest inflation rate, 24 per cent per annum, was in 1994.

On the expenditure side, the fiscal authorities have also been very prudent, conservative even. Pure interregional fiscal transfers have been kept to the minimum because of insufficient amount of formula-based transfers, and majority of the central government's transfers to local levels has been project-based. Although this tends to increase regional imbalance, project-based transfers have been production-enhancing as they are used mostly for building infrastructure (Yao 2008). Before 2003, social spending was maintained at a minimum. Although social spending has picked up slowly in recent years, its share in government budget is still low. Indeed, the government is frequently criticized for spending too little on social protection.

In terms of taxation, the overall tax burden in China declined dramatically between 1978 and 1993 due to fiscal decentralization. Prior to 1993, government revenue was only about 17 per cent of China's GDP (Yao 2008). The 1993 fiscal reform greatly strengthened taxation capacities of the governments, bringing the amount of government revenues close to one-fourth of GDP. But the fast growth in government revenues has raised concerns from both society and the government itself. The rate of corporate income tax was lowered from 33 per cent to 25 per cent; the deduction of personal income tax was raised several times; and the value-added tax is likely to provide relief for capital investment. It is noteworthy that the competition among the regions for funds has played a role in curbing the growth of government revenues.

On the international front, China has taken a road that has decisively led to liberalization of trade and foreign direct investment (FDI), even though the country has successfully followed its own pace of opening up. Openness, especially in the form of the special economic zones, was the centrepiece of China's reform policy for most of the last thirty years. Export-led growth was adopted as a national development strategy in the mid-1980s. Joining the WTO in 2001 marked China's full integration into the world economy. Since then, China's trade dependence ratio, i.e., the ratio of imports and exports in GDP, has been in excess of 60 per cent, the highest among the large economies. Besides trade, China began to open to FDI in the early stage of development: the fact that 60 per cent of China's exports are contributed by FDI firms is indicative of the depth of FDI involvement in the country.

China's domestic reform targets were privatization and deregulation, which aimed to remove the two pillars of economic planning: state ownership and price control, respectively. After fifteen years of privatization starting from the mid-1990s, most of the state-owned enterprises (SOEs) are either in private hands, or have transformed into public companies listed on the stock market. Only a handful of powerful SOEs are still owned and controlled by the government. Price control was dismantled even prior to privatization, and the government reform at the end of the 1990s further removed many of the barriers of firms to entry and exit.

Although protection of property rights is still weak in many arenas (especially intellectual property rights), PRC has made noticeable progress. The flourish of private firms indicates that private ownership has been respected, at least to a certain extent. Several amendments to the constitution and enactment of the property law have established a reasonable (albeit incomplete) legal framework for property rights protection. The situation is far from perfect, but is decisively headed towards better, stronger protection.

In addition to China's conformance with the Washington consensus in its transition goals, the country adopted other policies frequently prescribed by the development economics literature as essential to economic growth. Among these, high saving and investment rates and an emphasis on primary education are two of the most significant. Although the income gap between rural and urban areas has widened, the dominance of labour-intensive exports has enabled China to shift 140 million rural residents from agriculture into higher-income industrial sectors. Sustained economic growth has lifted more than 200 million people out of absolute poverty in the past three decades. Thus, the Chinese growth has been largely inclusive, which lends support to the emerging agreement in the literature of the causal relationship going from equality to growth.

Countries that have adopted the right economic policies, however, have been a minority among the developing countries. Only 13 economies have been able to maintain an uninterrupted growth rate of 7 per year or more for 25 years or longer after the Second World War, and most of these are in east and southeast Asia. The lack of knowledge cannot explain why most countries have failed to adopt the appropriate economic policies because, for one, only basic economic training is needed to understand these policies. In addition, such policies have been frequently advocated or even imposed on the developing countries by international donors as a precondition for aid. A serious study should therefore be undertaken to look at the reasons why governments in most developing countries have failed to adopt the right economic policies.

### **3 Authoritarianism, or something else?**

In searching for a political economy explanation for China's economic success, the easy answer could be that the country benefited from the authoritarian state. The proponents of this concept would argue that an authoritarian state has the power to mobilize people and resources in striving for high economic growth. This seems to be the accepted wisdom within the international arena and is often echoed within China as well. In a recent article, the former American Secretary of State Condoleezza Rice (2008) writes:

Democratization is also deepening across the Asia-Pacific region. This is expanding our circle of allies and advancing the goals we share. Indeed, although many assume that the rise of China will determine the future of Asia, so, too—and perhaps to an even greater degree—will the broader rise of an increasingly democratic community of Asian states.

Clearly, Ms Rice implicitly excludes China from the democratic camp and links China's future dominance to the authoritarian nature of its state.

However, the authoritarian state was neither a sufficient nor a necessary condition in order for China to achieve its high economic growth. As the experience of China shows, the existence of an authoritarian state is not sufficient because it may embrace wrong goals or represent the interests of small groups of people. Its growth record during the planning period was unimpressive even though the country was decisively more authoritarian at that time than during the subsequent reform period. The right-wing military regimes in Latin America that protected the interests of the elites and suppressed the demands of the majority, exemplify the second condition. This narrow mandate made sustained economic growth impossible and led to the collapse of these

regimes. An authoritarian state is not a necessary condition for high economic growth, as some democracies have also achieved record growth. For example, Botswana is functional democracy and is among the thirteen countries enjoying sustained economic development in the post-war period. India, also a functioning democracy, has recorded substantial growth since it began reform in 1991. A democracy can be slow in reaching a consensus, but is not intrinsically incongruent with economic growth.

Indeed, the dichotomy between authoritarianism and democracy itself is misleading. Even the most democratic countries, if they are built on the concept of representation, the ideal virtually all democracies adhere to, contain authoritarian elements. The most telling example was President Bush's insistence on continuing the Iraqi war despite its unpopularity in the United States. Conversely, even the most authoritarian states leave space for democratic decisions. For example, farmers in the communes discussed economic decisions and voted on these even in the heydays of China's planning era, which was characterized by political and economic controls. Most countries fall between absolute democracy and absolute despotism. The Chinese state, although dominated by an authoritarian polity, does not lack space for economic liberty, popular political participation, and even genuine democracy.

The Chinese Constitution permits a considerable degree of popular participation. Each village is defined as a self-governing entity: the farmers themselves elect their leaders and decide on village affairs. Above the village is the local legislative body to which delegates are directly elected. The same applies to the people's congress at the district level in the cities. Above the county and district administrative levels, delegates are elected indirectly to the municipal, provincial, and national people's congress by the representatives of county and district people's congress. At all administrative levels, the people's congress has rights similar to those in any other country embodied by their parliament. The problem is that these rights in reality may not be fully exercised, but positive progress is happening at the grassroots.

The most significant progress is the village election. China started to experiment with village elections as early as the 1980s. In 1988, the National People's Congress (NPC) passed an experimental version of the Organizational Law of the Village Committee stipulating that the village committee—the self-governing body of the Chinese community—must be elected. This law triggered wide-spread elections across the country. In 1998, the NPC formalized the law, with the condition that the candidates for the village committee had to be nominated by the villagers. Currently, democratic elections are common in almost every village, and the outcomes are quite encouraging, enhancing the accountability of the committee. In particular, the process has increased public spending while simultaneously reducing the share of administrative spending in the village budget, improving income distribution, and leading to more public investment (Zhang et al. 2004; Wang and Yao 2007; Shen and Yao forthcoming).

Delegates to the township, county and urban district people's congresses, the administrative levels above the village, are directly elected, as required by the constitution. Although nomination is not free from interference by the government, there are signs that elections have become more competitive in some localities. Concurrent with this trend, county and district people's congresses are becoming more effective in monitoring government functioning, especially budget allocations. At the national level, both the NPC and NPCC (National People's Consultative Conference) are involving more members with professional backgrounds. Although the political



structure has remained more or less intact, inclusion of these new members will enhance the ability of the two legislative bodies to monitor the government. Although the system is still far removed from a true democracy, democracy as a long-term goal has taken roots in China, and even top government leaders do not deny the fact (Thornton 2008).

There is also considerable room for free speech within China's one-party system. Although there are still areas—noticeably foreign policy, religion and the one-party rule itself—where open public discourse is restricted, the press is quite candid in other areas including government policies in social and economic arenas, corruption, and democratization. In addition to traditional media, the internet has provided unprecedented freedom for personal expression including dissident views on China's political system. These views have gained weight in the country's political process, and government leaders at various levels take these into account in their decisionmaking. Intellectuals have actively participated in public debates, and although a certain degree of censorship still exists, their views are often heard and tolerated even when very radical.

A new development is that the civil society has become much stronger in today's China. Non-governmental organizations have been accepted, at least to complement governmental actions. More subtle, but more important development happens at the grassroots level. Old communities are reviving as life becomes more stable and income increases considerably, and new communities are emerging on the basis of common interests in addition to geographic proximity. This includes private clubs related to common interests (driving, tourism and so on), intellectual circles as well as residential communities. The internet plays an important role in these grassroots organizations. Although politics is often deliberately excluded from the agendas, these newly emerged communities can quickly form organized resistance, should their interests be infringed upon by the government.

In light of the above evidence, one has to realize that the Chinese state is more complex than can be described by the term authoritarianism, and its success in adopting the right economic policies needs to be explained by a mechanism more extensive than the obvious authoritarian elements. In order to offer general implications, this mechanism needs to encompass authoritarianism and democracy because successful stories are evident in countries that can conventionally be defined as authoritarian and democratic. One such mechanism is the disinterested government identified in this paper. In the next section, we provide a general discussion of this concept and its implications for economic growth.

#### **4 Disinterested governments**

By a disinterested government, we mean a government that is impartial towards different sections of the society. To be more precise, it is a government that does not form an alliance with, or provide favourable treatment to, any specific social section. It is not necessarily a neutral government lacking its own interests. It can, instead, have its own agenda and self interests. The key argument here is that a disinterested government is more likely than a partial government to adopt growth-enhancing economic policies even beyond its own strategic choices.

A partial government, by definition, prioritizes or favours the interests and welfare of certain groups of people over other population groups. This hurts long-term growth. When the represented groups do not have political dominance in the country, it leads to competition among interest groups which in turn, as Mancur Olson forcefully argues in his seminal 1982 book, demands are greater for redistributing the resources than for enlarging the pie. When the represented groups have the political and social power to suppress others, it gives government the freedom to advance only the interests of the represented people, ignoring others. Often, in developing countries, the dominant political groups are comprised of a small number of elites, and this explains to a large extent the extreme income inequality in these countries. Curiously enough, it is in these countries that populist governments are more likely to emerge. This is largely the result of the backlash of the poor for regaining power from the elites. A populist government, even though it represents the majority of the society, is not a disinterested government, precisely because it aligns its interests with those of a specific group of people. Both theory and empirical evidence show that long-term growth is not possible under a populist government because a populist government, by definition, is obliged to engage in redistribution to please the populace. If it serves to enhance people's ability to generate income, redistribution does not hamper growth. However, most governments of this type go beyond that characterization, promising expensive welfare programmes to win the support of ordinary citizens, and these have to be compensated by slower capital accumulation and ultimately slower economic growth. Argentina under Peron's rule is but one example.

A disinterested government can still be predatory, but less so than a partial government. First, a disinterested government is more likely than a partial government to treat each population group equally. This is because differential treatment of the various groups induces no specific gain, but increases the chances of challenge by the mistreated sectors. It might be worthwhile for a government to harbour predatory behaviour towards weak rather than strong groups. But the stock of wealth held by weak groups can be small, and once predation exceeds a certain level, the masses may revolt. Fair treatment of each group is, in most cases, the optimal choice for a disinterested government. Thus, disinterested government tends to be more concerned with—or, to be more precise—to pursue interests that coincide with those of the entire society. Consequently, it is more likely to care about the long-term welfare of the populace than a partial government because equal treatment reduces redistribution demands (Alesina and Rodrik 1994). As we argued before, populist pressures are more severe in countries with divisive social groups where ordinary citizens perceive themselves as being exploited by the elites.

As the pursuit of economic growth is likely to coincide with the long-term welfare of the whole society, improvement is more likely to happen under a disinterested government than a partial government. Unfortunately, there are more partial governments than disinterested governments in the developing world. Two archetypes of governments typify that part of the world: the elite and the populist governments. Of course, purely elite-dominated governments and purely populist governments are exceptional in today's world, but the combination or alternation of the two is often observed. Many south and southeast Asian countries are characterized by the mixture of elite and populist politics, while those in Latin America are an alternation of the two. These countries started with elite dominance, but democratization opened the door for popular participation. Greater popular participation would have been a virtue, had these countries had social equality. The elites, however, have continued to dominate socially,

politically, and economically, which means that ordinary people are not getting their proportional distribution share of the increasing pie. As a result, they prefer to demand for greater redistribution instead of making investments for the future.

There were also certain impediments to the emergence of a disinterested government in China. In addition to the objective of fast economic growth, China needed to complete the transition from a planned economy to a market-based one. Except for a few reforms (the rural reform) that were Pareto improving, most measures have involved substantial reconfiguration of the gains and losses among different population groups. Reforms would have not moved towards the market if the government had hesitated over the interests of specific groups. Furthermore, China is a vast country with one of the most decentralized fiscal systems in the world, which created strong local concerns not always aligned with those of the entire nation. While fiscal decentralization may enhance local incentives for local economic growth (Qian and Weingast 1997), it leads to regional protectionism, inferior provision of public goods within the relatively large scope of geographic coverage, and perhaps most significantly, the commercialization of local governments. Oi (1992) describes the behaviour of local governments in China as 'local state corporatism'. But in reality, local governments are more than authoritarian identities able to contain the local forces; they have become companies advancing their own interests only, and it often falls on the central government to bring local interests in line with the national agenda. However, the central government itself is segmented by ministries that have their own patronages and interests. Most industrial policies are proposed and formulated by the ministries and it is not uncommon to find that they are embodied in special industrial groups. Ministries also keep extra-budgetary revenues that bypass government auditing. In summary, it is not nature for a disinterested government to emerge either in China or other developing countries.

It is noteworthy that our notion of disinterested governments shares some commonalities with Olson's concept of encompassing organizations. Olson (1982: 47) defines these as organizations that 'encompass a substantial portion of the societies of which they are a part'. That is, they represent a significant share of the population in a country. What makes a difference is that 'the incentives facing an encompassing special-interest organization are dramatically different from those facing an organization that presents only a narrow segment of society' (Olson 1982: 48). This can be illustrated by two related arguments. First, because it represents a significant portion of the population, an encompassing organization cares more about the growth of the national economy than the entities representing only a very small group. As a result, it is less likely to introduce anti-growth policies. Second, an encompassing organization is also less tolerant of the heavy costs imposed by excessive redistributive policies, again because it represents a large portion of the population. As a result:

Encompassing organizations have some incentive to make the society in which they operate more prosperous, and an incentive to redistribute income to their members with as little excess burden as possible, and to cease such redistribution unless the amount redistributed is substantial in relation to the social cost of redistribution (Olson 1982: 74).

Disinterested governments, in favouring societal outcomes over specific-group interests, do not differ much from the encompassing organizations with respect to their ultimate results, but the mechanisms in these two concepts are different. While Olson considers the size of an organization as the central pillar for being encompassing, we emphasize

the detachment of a government from specific groups as the key for its concern of the whole society. An example to distinguish these two mechanisms is given by the political arrangements of the medieval Genoa (Greif 2006), where initial politics was characterized by competing clans, none of which had absolute dominance. As a result—because of the lack of an encompassing organization in the sense implied by Olson—the city was engulfed by prolonged clan fights and instability. The solution proposed by the clans was to hire a *podesteria* (a knight with his own army) to run the city. Making money was the *podesteria*'s primary goal, but since he was an outsider with no personal ties to any clan, he was more likely to take a neutral stand on city affairs, and for that matter, was more likely than an insider to advance the city's long-term welfare. In other words, the *podesteria* acted like a disinterested government although he and his army were few in number in relation to the population of the city.

Under the two concepts, policy recommendations, in addition to the mechanisms, can also be different. In a democratic polity, or any polity with a reasonable range of political diversity, it is hard to find an encompassing organization because none of the organizations can be large enough to act in an encompassing way. However, a disinterested government may still emerge in a very diverse society if the ruling group remains autonomous relative to the society.

Lastly, the concept of disinterested governments has more operational values than that of encompassing organizations. For example, we can tell when a government is disinterested by checking whether different population groups are given equal treatment with regard to taxation, subsidies, government services, and political concerns, but we are not sure how large an organization should be in order to be considered as encompassing. Indeed, in a parallel theoretical paper, my coauthor and I (He and Yao 2008) define a disinterested government as one that maintains the same rate of taxation (predation) and provides the same level of government services to two distinctive groups of citizens.

## **5 The Chinese government as a disinterested government in the reform era**

As was pointed out in the introduction, China's economic success needs to be traced back to its underlying political economy. But the excellent economic growth record is not evidence of the Chinese government being disinterested in the society. Instead, we need to show that the government has behaved in a disinterested manner when decisions involved interests that conflicted among different segments of society. This section provides three examples to show that the CCP prioritized the overall welfare of the society over segmental interests, even when this implied that its own powerbase interests were at risk. Next we discuss (i) the emergence of the growth consensus at the beginning of economic reform, (ii) the evolution of the dual-track price system, and (iii) reform of the state-owned enterprises. These three areas illustrate some of main thrusts of the disinterested nature of China's officials during the last thirty years.

### **5.1 The growth consensus**

Since the Opium War, a strong China has been the dream of several generations of Chinese leaders. Its encounter with the western powers in the 1800s taught China the painful lesson that without economic power, it would be bullied by others.

Unfortunately, economic growth was interrupted by civil wars, the Japanese invasion, and the incompetence of the Guomintang government. The establishment of the People's Republic in 1949 gave the country a chance to concentrate on economic growth, but the dream was shattered repeatedly by political movements. The pragmatic leadership centred around Deng Xiaoping in the late 1970s finally enabled China to pursue its century-long dream of economic prosperity. The growth consensus emerged as a way to unite the country towards that goal.

The essence of this consensus was to prioritize economic construction in all government and societal endeavours. The CCP quietly abandoned its conviction of an egalitarian society and began—in Deng Xiaoping's words—'to let some people get rich first'. In other words, CCP's agenda was shifted from redistribution to economic growth, thus accomplishing one important step from a populist government to a disinterested government. This was not easy, as can be expected in a country that had been dominated by orthodox Marxist teachings. To win popular support in the party, Deng Xiaoping initiated the 'truth debate' at the end of 1978. The issue was not a debate on whether to have more markets, but was framed in a philosophic discussion about the sources of truth. This proved to be a wise political strategy; it disguised the true intention under a classical Marxist issue, preempting a rejection by the conservatives to the debate. The conclusion was that there could be only one source of truth, and that was practice. Thus, a door was opened to experiment and change. These would ultimately transform China into a totally different country, but at the time, leadership was determined that embracing the market was the only option if China were to start growing again. To forestall rebuffing by the conservatives, Deng Xiaoping set the tone by stating simply: 'Do not debate'.

The growth consensus accomplished several results. First, it unified the party and the country. After the dark years of the cultural revolution, people were tired of the political tempo and needed a new direction. The CCP itself was divided. Mao's successor, Hua Guofeng, despite being more rational than the ultra-radicals of the cultural revolution, still held on to Mao's legacy and further steered China in a radical direction. Deng Xiaoping and other moderates believed that changes were needed, but did not want to have a head-on confrontation with Hua. Shifting the party's emphasis to economic construction would induce changes in the system, but in the same time it would also preempt objections from the radical camp.

The second accomplishment was in the area of system changes. Some of these changes had been envisioned and planned by the moderate camp: for example, the increase of agricultural prices had been a planned move to stimulate grain production, but many other were unanticipated, as the return to family farming, but since it increased output, family farms were accepted, encouraged even, by the CCP. The rise of the rural industry and privatization of SOEs were other examples. Once the goal was set, institutions became the tool to realize it.

The third accomplishment was the change in the ideology of the CCP. Starting first with the notion of allowing some people get rich, the growth consensus watered down the party's old convictions. After thirty years of evolution, the CCP today is no longer a party built on political ideology. We will come back to this topic at the end of the section.

The growth consensus had other unintended and adverse consequences as well. In regions where economic growth has been overemphasized, environmental degradation, social inequality, erosion of the social safety net, and even the commercialization of local governments are common. A discussion of these consequences would be a diversion to the theme of this paper, but it is worth emphasizing that while the growth consensus, on balance, has served China well in the last thirty years, its continuation unaltered could change from a virtue to a vice.

## **5.2 The dual-track price system**

The dual-track price system was a compromise reached in 1984 between the radical abandonment of and continuous adherence to socialist planning. Under this system, SOEs were allowed to sell their products and buy inputs in the free market once their planned quotas had been fulfilled. Market prices were higher than quota prices. The most significant example was the dual exchange rate regime that was in place between 1984 and 1994. The central government maintained an official exchange rate, but at the same time opened a swap market in Shanghai where enterprises had some freedom to buy and sell their foreign earnings at a higher, but floating exchange rate.

The dual-track price system had opened the door for economic incentives to play an important role in SOEs' decisionmaking. Its unintended consequences, however, may have been more significant than the impact on SOEs. For example, the dual-track system enabled non-SOEs to thrive, as exemplified by township and village enterprises (TVEs). Central government's planning did not extend to these rural enterprises, and it was difficult for them to buy materials or sell their products before the reform. Although they exhibited extraordinary growth in the 1970s (Lin and Yao 2001), their contribution to the national economy was marginal. The dual-track price system gave the TVEs access to markets and inputs, enabling them to prosper.

Lau, Qian, and Roland (2000) believe that the dual-track price system had brought Pareto improvements to China. To a large extent, this assessment is true. However, the dual-track system also had serious downsides. Price differences, sometimes extraordinarily high, created space for rent seeking. Enterprises and government officials who controlled the quotas could easily get rich by selling their quotas to other enterprises and individuals. At the end of the 1980s, *guan-dao*, or official profiteering, became a popular phrase, creating deep public resentment. However, the people who controlled the quotas were CCP insiders, and according to many scholars (e.g., Murphy, Shleifer and Vishny 1992), this made further changes to the system very difficult.

But the CCP proved this prediction wrong. Dual prices began to converge in the early 1990s, and by 1994 the dual exchange rate, the last of the dual-track system, was dismantled. The CCP was not held back by vested interests. Instead, it had the resolution to eliminate the privileges enjoyed by its own insiders.

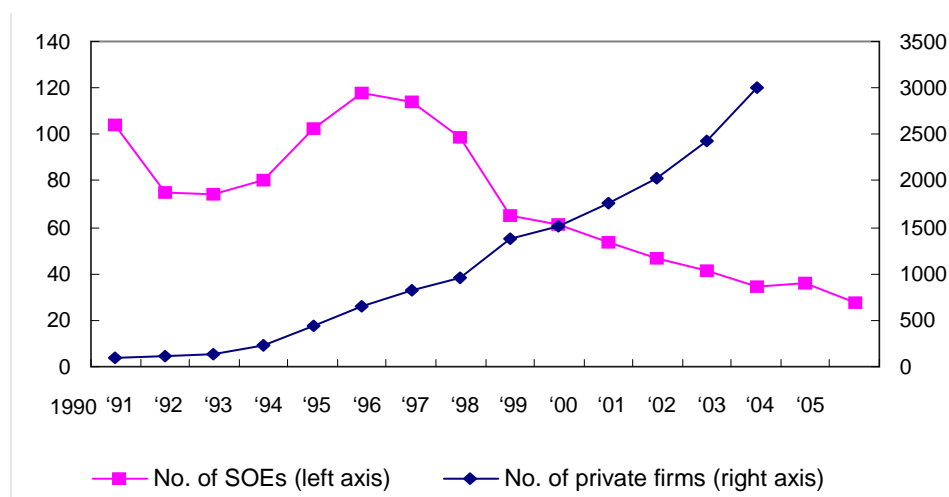
## **5.3 SOEs privatization**

SOE privatization is the best example of the Chinese government's disinterest. Restructuring of the SOEs was a major aim since urban reforms began in 1984. Although there were calls for privatizing the SOEs, the government's initial emphasis was on boosting performance by changing the internal governance of these entities

through contracting. After Deng Xiaoping's visit to southern China in 1992, serious privatization started in several localities (Huang and Wei 2001; Yao 2004). In 1995, after extensive discussion, the central government adopted the policy of *zhuada fangxiao* (or 'keep the large and let the small go'), according to which the state decided to retain 500-1,000 of the large state firms, with smaller firms being leased or sold. From the policy came the term *gaizhi*, which means 'changing the system' and in many cases, this meant privatization. By the end of 1998, more than 80 per cent of state and collective firms at or below the county level had gone through *gaizhi* (Zhao 1999). By 2005, 76.7 per cent of all the industrial SOEs existing in 1995 had either been privatized or gone bankrupt (Figure 1).

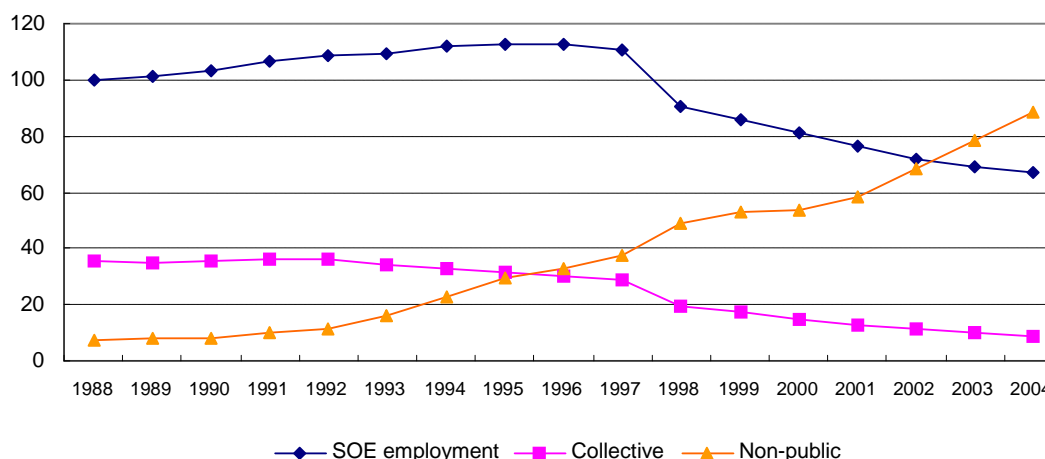
1995. The cutback in collective firms was smoother, but much deeper, and by 2004, their employment share was only one-fourth of the 1991 level, which was the highest year of the 1990s. Between 1988 and 2004, non-public sector employment increased 24-times to become the largest urban employer, hiring 71 per cent of the urban labourforce. In fact, the non-public sector became the largest sector already in 1998.

Figure 1  
Number of SOEs and private firms in China's industrial sector (1,000)



Sources: NBS (1990-2005); NBS (1990-2004).

Figure 2  
Urban employment in SOEs, collective firms and non-public firms (million persons)



Sources: NBS (1988-2004).

It should be noted that privatization may not necessarily be the reason for large-scale unemployment. On the contrary, Huang and Yao (2006) find that privatization even increased employment because of better performance. There were redundant workers in SOEs before privatization, many of whom had not been paid for years. Privatization, however, triggered the shake-off of these workers. There had been numerous protests in the country against privatization. This was a serious challenge to the CCP, causing a dilemma: if it supported privatization, it would lose the support of the working class, its own powerbase, but in giving up privatization, institutional transition would be halted and China would lose the opportunity to catch up with the developed world. CCP solved the problem by quietly continuing with privatization while striving to reemploy laid-off workers. This strategy worked. By the mid-2000s when the privatization of SOEs was being concluded, most of the unemployed had new jobs or were on government welfare programmes. Privatization, however, had shattered the old beliefs, and the CCP needed to create a new ideology.

The above reveals the main three thrusts of the disinterested nature of the Chinese government. First, the growth consensus indicated that the government was able to unite potentially diverging forces towards the goal of economic growth. Often in developing countries politics are so divisive that it may become virtually impossible to form a consensus even on the most obvious improvement to national economy. Second, the convergence of the dual-track price system towards the market highlights that the CCP was willing to eliminate the privileges of its own members, or in other words, to disregard the interests of the elites and adopt policies that were beneficial to the whole society. Third, the SOE reform shows that the CCP was able to resist populist pressures in adopting a more efficient ownership structure even at the expense of its powerbase. Next, we show why the Chinese government has been a disinterested party over the last thirty years.

## **6 Factors leading to a disinterested government in China**

Why has the Chinese government, and the CCP in particular, been disinterested over the last three decades? There may be many reasons: the Confucian culture; China's humiliating history after the Opium War; and the political structure and dominance of the CCP. But these factor may be too specific to China to have any implications for other developing countries. In this section we attempt to provide three reasons which may have some general implications for other developing countries.

### **6.1 Lessons learned in the 1949-78 period**

The 1949 Communist Revolution and the ensuing land reform and nationalization of industry created an equal society in China. It would seem that the CCP chose to behave in a disinterested way; after all, the vast majority of the population at that time belonged to the peasant and worker classes, and it seemed odd that the CCP's aim to serve these two classes could hinder it from being an encompassing organization. But like Argentina during Peron, the CCP's policies between 1949 and 1978 had a strong populist flavour, albeit under the cover of a socialist state.

In the rural regions, family farming was quickly replaced by the people's commune; where peasants were forced to work together. The 1958 'great leap forward' had



disastrous results, including a grand scale famine. The commune system established after the great famine featured a work-point remuneration system that, regardless of actual effort, treated adult labourers more or less the same. The system resembled a form of taxation which taxed the more able people and compensated the less able workers.

In the urban communities, salaries were very low, but state-sector employees were heavily subsidized by the government through food, health care, pensions, housing, and children's education, placing a considerable burden on the government. In addition, the cities obtained net transfers from the countryside through the so-called 'price scissors', despite the already difficult life of the peasants.

In addition to detrimental policies, the focus in the political arena was on class struggle. Any unorthodox action, such as selling one's sideline products on the market, or even raising large-sized livestock was regarded as a sign of 'going the capitalist road' and quickly suppressed. Class struggles should have been the means to protect working class interests, but ultimately became a weapon against the working class itself. Furthermore, the entire country was to fall to political hysteria during the cultural revolution. Anyone daring to deviate from the political stance could be accused of being a class enemy and sent to labourcamp. Class struggles became a convenient weapon for one group to suppress another group.

After the cultural revolution ended with Mao's death in 1976, CCP moderates began to rethink implemented policies. One fact became obvious: the hyper-concentration of serving and relying on the working class would not benefit the country in terms of economic growth and would, in the end, hurt the working class itself. After the Third Plenum of the Eleventh Party Congress in November 1978, the term 'class struggles' was permanently eliminated from official Party documents and public discourse. The CCP embarked on a road towards a disinterested organization.

## **6.2 An equal society**

China had become an equal society already in 1949, but the CCP's intent on being a working-class party hindered it from being disinterested in the society. After the emphasis began to fade during the reform era, social equality enabled the CCP to adopt growth-oriented policies in several fields.

First, egalitarianism has ensured that the CCP members came from roughly equal social groups, so the party was not burdened by class origins. This can be contrasted with the National Congress Party (NCP) in India, where most of the founders (such as Gandhi and Nehru) were Brahmins, and throughout history, it has largely remained a party controlled by the upper castes. This has hindered India's efforts to implement land reform after independence when NCP had monopolistic political power in the country. CCP's dispersed membership allowed it to implement policies that were better for the country as a whole than for specific classes.

Second, an equal society has prevented the CCP from being captured by vested interests. In connection with dual-track prices, the CCP leadership overrode conventional wisdom by depriving some of the party officials of the privileges they had enjoyed because CCP was aware that the vast majority of Chinese people would support its actions. The same is true for the CCP's continuous fight against corruption. Had the

country not been equal but controlled, instead, by powerful segments on whom the CCP depended (as happened to Guomintang in the past), it would have been hard to imagine the CCP having moved so boldly against corruption.

Third, an equal society has also facilitated the success of the growth-oriented policies undertaken by CCP. Take the example of fiscal decentralization. If Chinese economists need to agree on one fact as the major reason for the country's economic success, it would have to be fiscal decentralization. But fiscal decentralization has not been a panacea. Fiscal decentralization certainly did not work in Russia, and has led to local governments in developing countries being captured by business powers. China stands out as a success largely because its society is relatively egalitarian at the local level; no one has the resources nor the will to capture the government. To the extent that recent literature has found a positive relationship between equality and economic growth, we believe that a society that is equal also in other aspects helped China to achieve high economic growth. This relatively 'easier' result, in turn, encouraged the CCP to adopt growth-oriented policies.

Some authors, discussing the political economy of the east Asian developmental states, have also emphasized the role of an equal society. For example, Woo-Cumings (1997) links Korea and Taiwan's economic successes to their relatively equal social and economic structures created during Japanese colonial rule, when rural elites and urban industrialists were suppressed to prevent organized upheavals against the Japanese. This adverse intention, however, created a favourable condition for these two economies to succeed because it uprooted the entrenched interests:

This discontinuity had a powerful levelling effect, equalizing incomes more than in most developing countries and providing a fertile ground for instituting effective interventionist states, which were given a relatively free hand to forge a developmental coalition as they saw fit (Woo-Cumings 1997: 331).

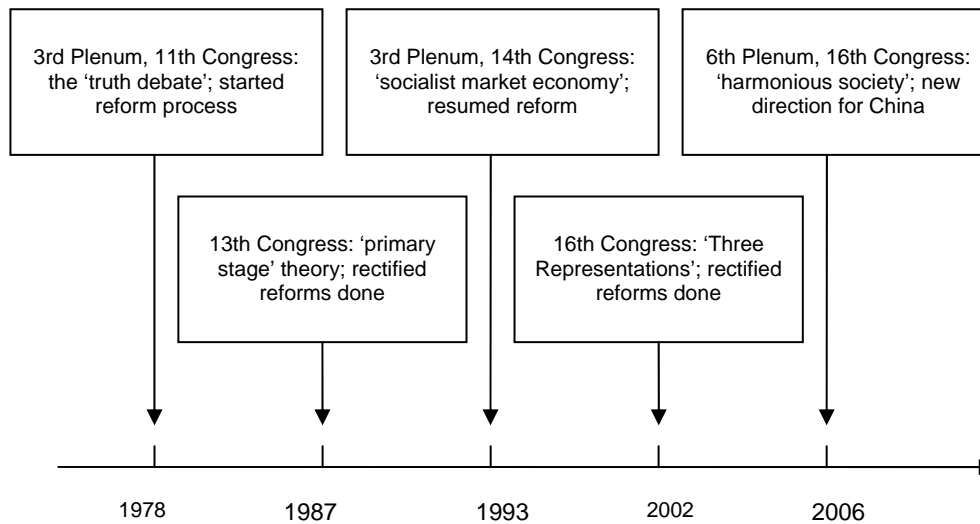
From this perspective, mainland China is not much different from Korea and Taiwan even though the equal social structure was created through its own revolutionary action rather than by foreign imperial rules.

### **6.3 The CCP's ideological adjustments**

In the last thirty years, the CCP has undertaken a series of ideological shifts, some small, some large, but the cumulative effect has been substantial. Maybe the central conviction—building a strong and equitable China—has not changed, but the ideas of how the society should be organized to achieve the goal have changed radically. The party has been transformed from a proletarian to an all people's party. Major ideological shifts during the period 1978-2006 are given in Figure 3, which identifies three main waves.

The first wave was between 1978 and 1987. The Third Plenum of the Eleventh Party Congress in 1978 started the reform process by giving up the radical ideology of the cultural revolution and adopting a pragmatic approach to economic institutions. Then in 1987 the Thirteenth Party Congress ratified the reforms that had been initiated almost a decade ago, summarizing them in the 'socialist primary stage' theory. This theory

Figure 3  
CCP's major ideological shifts: 1978-2006



abandoned the goal of building communism in China, emphasizing instead that the country was still in the primary stage of socialism and should thus adopt a flexible approach to economic institutions.

The second wave lasted from 1993 to 2002. After the 1989 Tiananmen incident, there was a major setback to the reform process. In the spring of 1992, Deng Xiaoping visited southern China, and reform was reintroduced. As official acknowledgement for the direction of the reform, the Third Plenum of the Fourteenth Party Congress in 1993 proposed the concept of 'socialist market economy', triggering the largest wave of reforms in the 1990s. The result of this wave in ideological shift was the announcement of the 'three representations' at the Sixteenth Party Congress held in 2002. The CCP no longer represented merely the proletarians, but also 'the requirements of the advanced productive forces in China, the future direction of China's advanced culture, and the essential interests of the vast majority of Chinese people'. The CCP has since then formally announced being a party of the country instead of the working class. In terms of its achievements in the 1990s—structural adjustment and SOE privatization—this declaration was not novel and indicated that CCP had given up its role as the guardian of the working class interests. In other words, it had declared being disinterested in the society.

The third wave is just beginning; its symbolic move was the announcement of the concept 'harmonious society' at the Sixth Plenum of the Sixteenth Party Congress held in 2006. A harmonious society embodies 'democracy and the rule of law, fairness and justice, honesty and mutual love, energetic dynamics, peace and order, and harmony between man and nature'. The key words are 'fairness and justice'. Along its road to high economic growth, the growth consensus accumulated many unresolved problems. One major consequence of the spearheaded growth of the last thirty years has been the expanding income gap between rural and urban residents. With urban per capita income being 3.3 times that of rural residents, China is the most divided country in the world, not only in terms of the urban-rural gap but also between the coastal and inland regions. Twenty-two million urban residents are on government welfare. This new wave of

ideological shift is aimed at remedying the adverse effects of high economic growth. Some people tend to believe that the shift symbolizes the return of the egalitarian policy of the past, but dressed in a populist coat. However, extreme inequality has been both theoretically and empirically proven to be detrimental to economic growth; therefore, this new shift of the CCP ideology is still consistent with its role as a disinterested government.

The first and third factors have implications for other developing countries because they show the importance of pragmatism in driving China's reform and economic success. Pragmatism rejects ultimate truth, and for that matter, it ought to reject first-best in policymaking. A pragmatist is always aware of the tentativeness of the current state of affairs including the institutions that run the society and is always ready to make changes as soon as minor improvements are possible. He is also keen to learn from his failures. The second cause is related to the social structure of a country. An equal society is beneficial in many ways; this paper shows that it provides a foundation for the government to act more in the interests of the whole society.

## **7 Conclusions**

This paper has provided a political economy explanation for China's impressive record of economic growth. Our explanation is centred on the notion of a disinterested government. We have provided evidence to show that China has indeed been characterized by a disinterested government during its reform era. We identified three factors which caused this development and which we believe will have general implications for other developing countries.

China is unique with regard to its historical and contemporary political settings. But the main idea emerging from this paper that remains valid for all the developing countries, is a disinterested government is the key to the adoption of pro-growth policies in a country. Most countries have failed to create such a government. It is a commonality rather than the exception that countries are either captured by business elites or hijacked by populist pressures. A society that is both economically and socially equal is more likely to create a disinterested government. Social equality is perhaps more important than economic equality because social inequality is often associated with races and stigmas, whereas economic inequality can be rectified by government policies.

One question remains: does the one-party system, as in China, hinder the applicability of the Chinese experience to other developing countries, many of which have at least a nominal democratic system. As was pointed out earlier, the CCP's dominance may have helped the Chinese authorities to develop into a disinterested government. This observation can remain valid, even when we are certain that the authoritarian state is neither a necessary nor sufficient foundation for a disinterested government to emerge. It is possible that the CCP's rule matched China's historical, social and cultural settings well to achieve a unique mix conducive to the emergence and sustainability of a disinterested government. However, even in that case, the Chinese experience provides a valid lesson for other developing countries. Every country is unique, but every country has elements conducive to economic growth, and it is the task of each nation to piece together the forces that dominate in the society. In a sense, it is not the form of the government that matters; what matters is the incentive structure of the society: the

formal and informal rules that guide people's actions. Each country should and can find ways to build up an incentive structure that is conducive for a disinterested government to emerge. Such a structure does not need to emulate any existing model, utilizing instead all resources, the traditional but also seemingly unorthodox mechanisms. Again, a sense of pragmatism will help.

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