Illustration by BINAY SINHA

The mechanics of the Chinese miracle

Bureaucrats become capitalists with the right set of incentives, says DEEPAK LAL

I have been visiting China periodically since 1985, and have personally witnessed the incredible changes wrought in people's lives by the Chinese economic miracle. The spectacular opening and closing ceremonies at the Olympics marked the emergence of China as the ancient civilisation which had once again regained its self-confidence. But there is a question that has always nagged me: how has a bureaucratic authoritarian state delivered the intense economic competition which is at the heart of a market economy without ceding any political control? A brilliant book by Steven Cheung (*The Economic System of China*, Arcadia Press, Hong Kong, 2008) at last provides the answer.

Cheung has used the insights he developed about share-cropping in his *The Theory of Share Tenancy* to explain the transformation of the Chinese economy from "one based on delineating rights in terms of hierarchy [through bureaucratic ranking] to a system of delineating rights in terms of property" (p.36). At the centre of this was the household responsibility system introduced in agriculture in 1978. This separated the 'ownership' from the 'use' rights to land, and was "the equivalent of the granting of private property rights via a state lease of land" (p.38). Difficulties in the application of a similar responsibility contract in industry lay in depreciable industrial assets, where questions of maintenance and reinvestment led to constant controversy between the authorities and the state enterprises. But as most of these enterprises were loss-making, their physical assets had become economically worthless by the early 1990s. The only constraint on closing them was that state employees could not be legally discharged. It was only with the rise in the value of their land in the late 1990s that they could be successfully privatised.

But, how did this rise in land prices occur? It was based on fierce local competition to get the largely private industries (most often the assembly platforms of Western multinationals) into their particular locality. I had observed this fierce competition, but had assumed that it was based on the corrupt 'rents' the local bureaucrats could earn by selling these 'use' rights to state land. But corruption on the massive scale that the observable explosion in industrialisation and urbanisation required, would have undermined the legitimacy of the Communist party, particularly with the rapid decline in popular adherence to the Marxist creed. Hence my puzzle: how had the Chinese state delivered the indubitable miracle based on the fierce competition of a market economy, without losing political control?

From his field research, Cheung found that, whilst there was corruption, it was not massive. More important, the Chinese had evolved a form of local bureaucratic competition based on granting 'use' rights to urban and industrial land without the need for corruption. At the heart of this was the evolution of a set of incentives provided to bureaucrats in *xian*s (municipalities) to act like landlords selecting and granting share-cropping contracts to investors. The economic power of the *xian*s lay in their sole right to decide and allocate the use of land. This right did not belong to villages, towns, cities, provinces or even Beijing. The *xian*s are part of seven geographically determined layers: country, provinces, cities, *xian*s, towns, villages and households. These layers are vertically linked by responsibility contracts (which, from their Chinese name, imply, "guarantee what I want and you can do what you want"). But horizontally, there are no contractual links and they are free to compete.

The pecuniary basis of the set of bureaucratic incentives at the level of the *xian* was a uniform national value-added tax (VAT) of 17 per cent paid by investors in a *xian*. The *xian* can keep a quarter of this VAT, which allows the bureaucrats to receive various perks like houses. This gives them the incentive to compete for maximising the VAT in their area. So the *xian*s are like landlords whose investors are like share-croppers, and they themselves are share-croppers with the upper geographical units. In his earlier work, Cheung had shown that, if the landlord could vary the share of output given by his tenants, he could obtain the efficient outcome, with the tenants putting in the optimum effort to maximise production.

But how could the *xian* 'landlord' ensure this efficient outcome if he could not vary the 'share', which is determined by the nationally uniform VAT? Cheung's answer is that, if the landlord is also providing 'capital', then by varying this, he can obtain the efficient outcome even if his share of output is fixed. The 'capital' that the *xian*s can offer are the price of land they charge investors and the costs of the infrastructure they provide, as well as rebates on the VAT to be paid. This is precisely how the *xian*s have competed for highly productive industrial investments in their area. A trip to the showpiece industrial park in Shozou near Shanghai (which we took with the Cheungs) provides a visible demonstration of this fierce local competition by using the 'capital' at their disposal to lure the high value-added, labour-intensive export industries that have made China the workshop of the world.

There is, however, a growing cloud on the horizon with the introduction of a new labour law with minimum wages, security of employment etc (reminiscent of India). Unlike past ones which the *xian*s ignored, it is to be centrally enforced. By raising the price of unskilled labour this would be a shot in the foot of the Chinese miracle, which has been based on free labour markets in an open economy. The best hope is that pragmatism will prevail and the *xian*s will be permitted to turn a blind eye to its local implementation. The reason for the introduction of this new labour law is the purported growing inequality in China. But as Cheung rightly notes, given the large floating number of workers who are classified officially as resident in the rural areas from which they migrated, and not considered residents of their new urban homes, there is a gross overestimate of the urban-rural per capita income gap as reported in official statistics and touted by international agencies like the World Bank. There is no reliable statistical information on which a robust measure of inequality in China can be based. As in so many other areas, letting the heart rule the head may yet stall the Chinese economic miracle.