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# China's Road to Capitalism

## How China Became Capitalist

by **Ronald Coase and Ning Wang**

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### I

Rapid changes taking place in Chinese society over the past few decades have not gone unnoticed. Both experts and laymen are particularly impressed by China's economic progress. Jeffrey Sachs stated that China is the most successful development story in world history. This fact has been viewed and interpreted differently by analysts. Thus, some follow China's progress with fear pointing to the dangers of potential Chinese domination ("Chinese imperialism"). Others think that it is certainly a "civilizational step forward" with far-reaching economic and political consequences, particularly emphasizing that the Chinese market transformation has opened new horizons of global capitalism.

In any case, what is happening in contemporary China strongly affects the whole world. Analysts have appropriately noted that China functions on such a large scale that it will inevitably change the global rules of the game. China is, according to Fareed Zakaria, "too big to hide" (Zakaria 2009). One fact is undeniable: contemporary China is a society in astonishing economic boom and deep social turmoil. With this in mind it was to be expected that China would become the subject of numerous studies in various scientific fields. There is already extensive literature about this topic, so that it is almost impossible to communicate to the scientific community and the general public anything new. Nonetheless, sometimes studies appear that bring new light to this complex topic, offering a different interpretation of the already known facts. The book in question is one of them.

The dramatic transformation of contemporary China raises numerous questions to the researchers: How was it possible in just a few decades for an economically extremely backward socialist country, which was struggling to feed its own population, to come to the world's economic top (economist Robert Fogel estimates that already in 2040 China will produce 40 percent of world's GDP)?; Was the transformation a result of China's well-designed and consistently implemented social and economic reform or was it part of something else?; How did changes come about?; On which ideas were they based?; Whence did resistance to change come and how it was overcome?; Has China become a capitalist society and, if so, what form of capitalism is it?; What problems and challenges will China have to overcome in the future? The answers to these and many other questions were given by Ronald Coase (recently deceased Nobel laureate in economics) and Ning Wang in this highly digestible and stimulating book. They offered their perspectives on how China "has become capitalist."

## II

The events that the authors refer to in this book are well known and are commented on by many of the analysts who deal with China's reform. These are actually the events that have marked the Chinese society after the Second World War. They first presented the key processes in the Chinese economy and society at the time of Mao Zedong. This period was marked by the strategy of the "Great Leap Forward" and the "Cultural Revolution". The first had the goal of rapidly catching up with countries that were already well advanced in their development. A variety of measures were used in trying to achieve that ambitious goal. Among other things, collectivization was carried out in the country and industrial production was fragmented (into a large number of small companies that were supposed to provide economic regional self-sufficiency). Changes were taking place in a climate of pronounced ideological resistance to everything that resembled private property and the market. The dramatic setbacks of both agriculture and industry were the direct economic consequences of such a strategy. Instead of the expected progress, China was facing starvation. On the other hand, the "Cultural Revolution" was a brutal attack on the Chinese cultural tradition. It was basically a radical anti-traditionalism aimed at the destruction of old habits, customs, culture and ideas. Both strategies resulted, as is well known, in enormous amounts of casualties.

Coase and Wang draw attention to the fact that in this period a combination of central planning and local autonomy was in effect and emphasize that the Chinese economy was still less centrally planned than the term "socialist economy" might suggest. At the time of Mao, China differed from the Soviet Union both in ideology and in organization. In other words, even during this period China was different from the other socialist countries. This was to prove, in the authors' opinion, extremely important during the period of China's transformation.

After Mao's death in 1976, questions arose as to how to proceed. Should the country continue in the same way, make a U-turn or choose some other strategy? In any case, the Chinese leadership could no longer keep their eyes closed to the problems and had to respond. Concrete action primarily meant making a decision about where they wanted to arrive. In short, it needed a "new vision" of Chinese society and the Chinese leadership was aware of that fact. An important change was that they began to think of economic development as a prerequisite for successful socialism. This orientation meant putting economic pragmatism in the foreground, and suppressing ideology. Misery, poverty and backwardness were considered the biggest enemies of China. Poverty was identified as a problem, not as a virtue, of socialism. The only real solution to this problem was economic development. Consequently, the modernization of China was set as a long-term goal of the reform. Coase and Wang later grouped the events that occurred into two processes. The first is related to market reforms under socialism; the other to the changes that have led to the abandonment of socialism (they describe this period as "building capitalism with Chinese characteristics").

### III

The key strategic move was the opening of China to the world, which primarily meant opening up to modern science and technology created by the capitalist countries. Basically, it meant opening to new ideas. China also began to learn rapidly from others in many areas (e.g. in 1980 Milton Friedman visited China and lectured to the Chinese leaders about the functioning of the price system and its importance for the market economy). China's state leadership under the influence of Deng Xiaoping made the decision to direct the economy towards the market, and the first attempt was in agriculture. China introduced the so-called accountability system. It tried to alleviate the problem of insufficient agricultural production with economic incentives to farmers. The cooperative system was abolished and the household became responsible for the land that it tilled. Households were free to keep or sell production that exceeded the prescribed quota. The area of land given out for private farming was also increased. The experiment proved to be extremely successful (this episode has even become part of the economic textbooks to illustrate the importance of incentives for economic efficiency).

Coase and Wang describe this process (as well as those that followed in other areas) as opening space to new economic forces on the sidelines of the socialist economy, exactly where state control was the weakest. In effect, it was a strategy of "try something new and wait and see what happens." The results were not known in advance and therefore could not be planned. Party leaders were often surprised by the positive results of certain measures (for their political promotion they subsequently sought to create the impression among the public that everything that happened was the result of their precise plan). According to Coase and Wang, this strategy was crucial for the course and results of China's transformation.

The real challenge for reformers was the industrial sector and the inefficiency of state enterprises. Chinese officials soon realized that the lack of autonomy in decision-making was the key problem of state enterprises. The solution consisted of giving more powers and responsibilities to managers. China later opened the door to foreign managers. Many foreign experts got employment in state enterprises, though Coase and Wang point out that their importance for the improvement of Chinese managerial knowledge should not be overestimated. Raising the efficiency of the company also implied changes in the employment policy, where lifetime employment was no longer an option. Changes in the reward system were also introduced. Bonuses and piece-rate payments were introduced in order to encourage commitment and improve productivity levels.

Viewed from a broader perspective, this first phase of the reform identified limitations of centrally planned economic management, but also the fear of letting the market regulate the economy. Thus, the question arose as to how to allow more economic freedom while maintaining a degree of control. The strategy of "a bird in a cage" was implemented. It was necessary to allow free movement of the "bird" (socialist economy), but only within the cage (central planning). Completely free, the bird would run away. Utterly disabled, it would die. As the economy grew, the "cage" also needed to change.

In practice, the "dual track system" was used, which involved the coexistence of central planning and the market in coordinating production in the state sector. The consequence was that in the public sector the operation of the market mechanism was manifested even without privatization. Practically, this meant that the government companies were required to meet the given quota, above which they were allowed to decide what to produce and how to do it, facing specific market signals that would guide them through the process. This is also reflected in the price system. The dual-track pricing mechanism was established: In the first track the prices are changed administratively and in the second they are left to the market. This mechanism had stimulated the operation of market principles, but when it came to its large scale application new problems arose. They could be solved only with complete reform of the pricing system that was to be inaugurated later. Coase and Wang believe that opening the door for the reform of the price system was crucial for changes in China because without it, it was impossible to stimulate the market and competition.

Opening to foreign investment in order to stimulate exports was particularly far-sighted. The first Special Economic Zones were established in 1980, which meant the inclusion of China into the global economy. They were supposed to serve as a laboratory for experimenting with the principles of capitalism and to enable direct "learning from capitalism." Initially, the goal was to use the knowledge thus obtained to promote socialism. The events would later get their own acceleration and focus would shift in another direction. China has gradually become one of the most desired destinations for foreign direct investment.

What was the ownership structure of the economy like? Concurrently, there were two economic sectors in action: the stagnant state economy and the growing non-state economy. It is important to note that not all of the non-state economy was in private hands. In the villages, as we have said, people's communes were replaced by family-run farms (private property was to be allowed later). There were state-owned enterprises and, on the other side, there were township and village enterprises which were managed by entrepreneurs. The advantage of these companies was that they were not under the control of the state bureaucracy. Consequently, they could adapt to market demands much faster and more efficiently. These companies were employing workers who emerged as the surplus in the agricultural sector and formed the backbone of China's economic growth. It is worth noticing that these companies have used labor-intensive production methods. Despite a rather hostile environment, the non-state sector has strongly progressed and increased its participation in the creation of GDP.

#### IV

The late Eighties (1988-1992) saw the global crisis of socialism and radical changes in the then socialist countries. At that time in China, strong resistance to the reform appeared. It was a period of doubt and re-appraisal. Specifically, hostility was expressed toward the private sector and privatization. The private sector was accused of being a bastion of bourgeois ideology. There was a danger that the reforms could be stopped. In such an environment, Deng decided to set out on a famous "journey to

the South" in 1992 which represented his support to free economic zones. That same year at the party congress, Deng argued that China needed to move from a "socialist planned economy" to a "socialist market economy." There were no more doubts. Thus was born the building, according to Coase and Wang, of "capitalism with Chinese characteristics".

Coase and Wang point out that 1992 was a turning point for Chinese reform. In fact, it was known as the "year of reform and opening." The first thing to be done was a thorough revamping of the price system. Price lists under state control were drastically reduced. Thus, the pricing system finally started to perform the functions that it normally carried out in market economies. As a consequence, the black market for raw materials was reduced to a minimum. Since then, almost all firms have paid the same prices for raw materials. The tax system was also reformed at this time. It was simplified and the national tax administration was established while institutions in the financial sector were revamped. All of these moves were aimed at eliminating discrimination, strengthening discipline in the overall Chinese market and ultimately promoting competition. Coase and Wang believe that during this period Chinese economists found inspiration in the economics of property rights. The key point is to perceive the necessity of clearly defined property rights and their protection as a precondition for a market economy.

We have mentioned that outside the public sector, which was state-controlled, new economic forces were in operation. Until 1992, however, they had not been officially recognized as an integral part of Chinese socialism. By that time, this sector had been discriminated against by very subtle measures. After 1992, private entrepreneurship imposed itself ever more strongly and today it is the key operational strength of the Chinese economy. In the mid-Nineties, a number of state-owned enterprises started the process of reconstruction or privatization. The number of state-owned enterprises has declined sharply since 2000, but these companies still account for a large percentage of the GDP.

However, despite the enormous economic growth not all of the old problems have been solved and new ones have appeared. The institutions that support the market are still underdeveloped when compared to the standards of Western countries. In some areas they are in their infancy. In addition, certain sectors of the economy remain a state monopoly (e.g. banking, energy, and communications). Coase and Wang note that such enterprises have become a powerful interest group in the Chinese economy. Since they are not under constant pressure of competition, these companies are not encouraged to innovate. The explosive economic growth increased inequality and deepened the differences in development between regions. Social tensions are the inevitable consequence of such a situation.

## V

What strategy of economic development has China adhered to? In response to this question, analysts emphasize several issues. One group of authors insists that it involves a consistent application of mercantilist measures followed by undervalued domestic currency (Antoine Brunet and Jean-Paul Guichard 2011). In the opinion of

Brunet and Guichard, China has created a very effective "cocktail" of capitalism and totalitarianism and, after 1989, it has been clearly implementing a form of economic growth based on foreign trade surplus. In their view, monetary protectionism has been a key economic weapon used by China after admission to the World Trade Organization. China's competitiveness in the global market results from the extremely low wages (measured by Western standards) that are maintained due to the inflow of labor from the rural sector. Some authors who share this view of China's development strategy consider that China is just repeating what was once done by the present-day developed countries. In part of the literature on this topic, it is particularly noted that the basis of success in China's transformation was a gradual, carefully controlled and limited liberalization. Thus, the emphasis is on the state and the Chinese model is referred to as state-guided capitalism.

On the other hand, Baumol and others speak about the different forms of capitalism which differ according to whether they encourage innovation and entrepreneurship (William J. Baumol, Robert E. Litan, and Carl J. Schramm 2007). They think that China is specific in relation to the capitalist economy because it has proceeded from the tradition of central planning, which has made it hardly comparable to any capitalist economy. It is therefore not surprising that China is developing a "unique vision of capitalism." Although the Chinese case certainly has elements of state-guided capitalism, the economic growth of China in their opinion was based primarily on stimulating entrepreneurial activity and not on state intervention. Zakaria believes that the momentum of entrepreneurship in China, among other things, was a consequence of a lack of coordination between the center and the regions, which opened up free space for action (Zakaria 2009).

Coase and Wang defend the thesis - the central thesis of their book - that China's transformation was not the design of the omniscient government. They are of the view that the development which has led China to its current economic position is not the result of a precise and detailed state plan with a clear endpoint, but rather a combination of fortuitous circumstances. According to their opinion, the Chinese reform is an example of what Friedrich von Hayek described as "the unintended consequences of human action", meaning that neither could anyone have predicted the final outcome nor intended it in the first place.

Coase and Wang assert that in the Chinese case, the state has without a doubt contributed to this transformation by gradually withdrawing from the economy (and consequently increasing economic freedom) and not by strongly interfering with this process; the state was opening itself to the market. The authors add that this does not mean that China's government is no longer an important participant in the economy. On the contrary to the usual understanding, however, they stress that it is wrong to interpret China's economic reform as a triumph of government intervention over market forces.

## VI

Appropriate conceptual basis was necessary to carry out the aforementioned transformation of the Chinese economy and society. Coase and Wang believe that Chi-

nese socialism was strongly influenced by China's long political and social history, i.e. it had specific features that made possible social and economic transformation of a certain type and dynamic. After the death of Mao Zedong, the question was how to change the society and at the same time create a sense of ideational continuity? How should the Chinese reconcile tradition and modernity? The authors emphasize that in the implementation of this delicate enterprise, the Chinese leadership acted pragmatically and not in bondage to any theory or ideology.

Most analysts of Chinese society emphasize the influence of Confucianism. It is claimed that Confucianism has had decisive influence on the character of Chinese social relations in the last two and a half thousand years. All those who seek to understand, particularly those who have the ambition to change the Chinese society, have to take this fact into account. Francis Fukuyama argues that the Chinese communists underestimated the power of Confucian culture and Chinese family and that this had disastrous consequences. Seen in this light, Fukuyama sees Deng's social reforms as a restoration of earlier Chinese relations (Fukuyama 1995).

In their analysis, both Coase and Wang point to the strong influence of Confucianism and - this is another key point - the interpretation of Marxism in this context. Deng believed that theoretical discussions would not lead to a political consensus nor would they provide practical answers to complex questions that would inevitably face the Chinese authorities. He admitted that he never read Karl Marx' "Capital" and the authors believe that it is quite possible that Mao did not systematically study Marxist theory. Mao insisted on the "practice as the sole criterion for testing the truth". Coase and Wang believe that Deng interpreted Marxism precisely in the pragmatic spirit of Confucianism. To simplify, it meant advocating the testing of ideas in practice and correction according to the results achieved without any dogmatism and ideological blindness. On the other hand, such an approach also contained continuity with the past.

According to this interpretation, China is the example of a country where the ideological fervor as the driving force was superseded by pragmatism and economic incentives, which proved to be far more effective. Chinese society has gradually changed and adjusted, i.e. not everything was destroyed and then created again. The result was that, within a short time, China has become, according to Coase and Wang, a "gigantic economic laboratory". What began as an "experiment in the margins" of a socialist economy was further developed and became a key strength of the Chinese economy. It triggered a process of institutional adaptation and collective learning. The market is, the authors insist, also a mechanism of collective learning. It requires constant change and adaptation for both individuals and businesses. Coase and Wang state that this is only the beginning of Chinese capitalism that will develop in harmony with "its own characteristics." It has yet to confirm its viability on the world economic scene in the decades to come.

## VII

Although the Chinese society is open, dynamic and full of creative energy, serious problems and challenges do exist. It is only natural that analysts raise the question of

what will happen with China in the future. There exist different opinions in the literature. Some analysts point to the enormous pressure of almost insoluble environmental problems resulting from the dramatic economic growth (Jared Diamond 2008). Another group of analysts believe that the key issue which the Chinese society will face will appear at the moment when political reforms become inevitable (Zakaria 2009). In essence, the full weight of the problem of maintaining a balance between political and economic reforms will appear in the future, which will happen when China comes, as they say, to the "threshold of democratic transition", i.e. when it becomes a middle-income country. According to some estimates, it is close to that border. Opinions differ on when China will (and whether it will at all) take economic leadership in the world. Some economists believe that, if there is to be a "Chinese century", it will not be in the 21st, but rather the 22nd century. Others still believe that the period of Chinese domination will occur much earlier, in the middle of the current century.

Coase and Wang are not engaged in this type of discussion; they draw attention to the issues that are already being observed in the Chinese economy. They point to a fundamental economic challenge facing the Chinese society whose outcome will determine its future. This is the challenge of global competition. In the first place, they remind us about China's low productivity relative to the world's major competitors. In addition, the authors state that although China has become a "world's workshop" it has not created a brand product by which it could be recognized in the West. The authors see a lack of innovation as a fundamental problem in this context; it is in their judgment a consequence of the absence of the market of ideas. Among other things, it has resulted from the organization of the educational system. According to Coase and Wang, the field of innovation is precisely where the decisive battle will be fought for the long term position of China on the world stage.

## VIII

Despite numerous studies in various fields, "the case of China" remains a topic that attracts a litany of researchers. Some are trying to sort out the key processes that marked China's transformation and - on this basis - formulate recommendations for other developing countries. There are also analysts who believe that China's transitional experience is so specific (in many fields) that it cannot be a pattern successfully imitated by others. Anyway, Chinese society is still a great mystery to Western analysts. The complexity of this issue is evidenced by the attitude of Coase and Wang's explanation that, in spite of numerous studies, we still do not know much about China's market transformation. They are sure of one thing: new research will undoubtedly bring new knowledge that can result in questioning some of the details, but it will not affect the global image of China's transformation that is offered in this book.



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