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Failure or Adjustment?: An Analysis of the Slowing Growth of the Chinese Economy

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With GDP growth for the 2016 fiscal year reported at 6.7%, it appears that the Chinese economy has departed from the three-decade period in which GDP growth averaged plus-10%. While both academic journals and media outlets have accredited this slowdown to a variety of factors, existing research has failed to conflate the economic and political factors into a comprehensive explanation. Consequently, this thesis examines the causative factors behind the slowing of the Chinese economy though the analysis of three contesting plausibility probes centered on the impact of corruption, statism, and structural economic change. The results of the plausibility probes indicates that while all of the hypotheses have had an impact on the slowing of the economy, the inability of the party-state to adapt its mode of economic growth in response the demographic changes that the Chinese population has incurred over the past three decades has had the largest demonstrable impact on the slowing of GDP growth.

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Chapter I:

Introduction and Literature Review

Chapter I

In celebration of the 80th anniversary of The Long March, China embarked upon a year-long celebration of national pride, prosperity, and achievement throughout 2016. Campaigns ranged from nationwide media and activism efforts to increase membership in the Communist Youth League of China to localized initiatives designed to raise awareness of the role of the party in fueling economic growth.[1] Throughout all of these events, the Chinese Communist Party (CCP) and corresponding state-apparatus promoted a message of national pride based upon the trials of the past, with an eye towards the future. However, these campaigns were also accompanied by an increased crackdown on dissidents who challenge this message, particularly on social media platforms such as WeChat and Weibo, highlighting the top-down attempt to increase the uniformity and positivity of messaging regarding the trajectory of Chinese growth over the last 80 years.[2]

In light of this message of positivity, from numerous perspectives the economic and social outlook for China looks bleak. The party-state posted a GDP growth rate of 6.7% for 2016, which, while admirable, is a dramatic departure from the 30-year period of plus-10% GDP growth on average carried from Deng Xiaoping through Hu Jintao. Additionally, deeper economic problems threaten to inhibit further growth, particularly the high-concentration of non-preforming loans (NPLs) on a local level, an increase in debt of non-financial institutions to 136% of GDP in 2015, the lack of state-control over capital inflows, and the lack of stability of

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[1] Xinhua, “Xi hails Long March as "epic," calling for realization of "centenary goals.” *Xinhua News,* 21 October 2016.

[2] David Bandurski. “Innovation, so the Party Can Shine.” *China Media Project*, 26 Sept. 2016.

guidance through periods of financial recession.[3] From a social perspective, the one-child policy has dramatically shifted the size and structure of the Chinese population, while education and an increase in the quality of life has shifted the interests and motivations of the workforce.

Based upon these seemingly contradictory indicators of the health and future of the Chinese economy, this thesis will examine why the Chinese economy has slowed, specifically within the framework of the role of politics and institutions of the party-state. Wide-reaching in nature, this analysis will touch upon factors pertaining to both the economy and the state apparatus, as well as the relationship and interplay between these two categories. This analysis will be operationalized within the context of a plausibility probe consisting of three contesting hypothesis. A plausibility probe can be defined as an attempt to determine if the potential validity of a hypothesis is reasonable enough to warrant further investigation into proving the validity of a hypothesis.[4] Plausibility probes are only utilized in order to determine which hypothesis appears to be the most valid given a preliminary investigation, and do not involve the use of further research to prove the actual validity of any hypothesis.[5] These probes are constructed in order to provide a method to determine which of the hypotheses is representative of the most plausible explanation for slowing of the Chinese economy given relevant available evidence.

Following a review of the relevant literature for both transition economies and the economic history of China since Mao, the subsequent sections will individually investigate each of these three probes in the context of how political and economic factors impact one another.

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[3] Jonathan Woetzel et. al. “China’s choice: capturing the $5 trillion productivity opportunity” *McKinsey Global Institute,* June 2016.

[4] Harry Eckstein. *Regarding Politics: Essays on Political Theory, Stability, and Change*. Berkeley: U of California, 1992. UC Books E-book Collection: 147

[5] Ibid.

Supporting evidence will include sources such as census data, government data on economic growth and industry, legislation, independently complied indexes and analysis as well as case-studies. Each of the hypotheses is grounded in a different reasoning for the slowing of growth, which in turn provides a unique explanation for the direction in which the economy is headed.

The following section will provide a contextual overview of the relevant historical background and academic literature pertaining to transition economies, with specific focus dedicated to the economic trajectory of China since Mao. Through constructing this thesis as a broad analysis as to the causative factors behind the slowing of the Chinese economy, this thesis is revisiting and contributing to the longstanding debates in economic literature concerning economic transitions. Defined as an economy that is transitioning from a centrally planned economy to a market economy, the branch of transition economics arose as many planned economies began to transition to market-based economy at the end of the twentieth century.[6] The International Monetary Fund (IMF) lists four components of economic transitions: liberalization, macroeconomic stabilization, restructuring and privatization, and legal and institutional reforms.[7]

Within these, liberalization is defined as, "the process of allowing most prices to be determined in free markets and lowering trade barriers that had shut off contact with the price structure of the world's market economies."[8] Similarly, macroeconomic stabilization is defined as "the process through which inflation is brought under control and lowered over time, after the initial burst of high inflation that follows from liberalization and the release of pent-up

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[6] Edgar L. Feige. "The Transition to a Market Economy in Russia: Property Rights, Mass Privatization and Stabilization." in *A Forth Way: Privatization, Property and the Emergence of New Market Economies*, edited by G. Alexander and G. Skapska, Routledge, New York, NY, 1994, pp. 57-58.

[7] International Monetary Fund. "Transition Economies: An IMF Perspective on Progress and Prospects." *International Monetary Fund*, (2000)

[8] Ibid.

demand."[9] Restructuring and privatization is defined as "the processes of creating a viable financial sector and reforming the enterprises in these economies to render them capable of producing goods that could be sold in free markets and of transferring their ownership into private hands," with institutional and legal reforms defined as "needed to redefine the role of the state in these economies, establish the rule of law, and introduce appropriate competition policies."[10] The IMF has classified a variety of Asian and post-Soviet countries as transition economies, including China, Poland, Romania, Vietnam, Laos, Croatia, Slovenia, and Uzbekistan.[11] Furthermore, the ten countries that joined the European Union between 2004 and 2007, including the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, Romania, and Bulgaria are no longer considered transition economies by the World Bank, as they have adopted enough market-oriented principles and practices to classify them as market-oriented.[12]

Given the expansive framework for economic transition theory as defined by the IMF, each of the counties classified as transition economies at any point in time has pursued different transition strategies, with varying outcomes. However, economic transition theory can be broadly divided into two contesting categories: rapid versus gradual transformations.[13] Prominent case studies of rapid transformation include Poland, Bolivia, and Russia. Likewise, cases addressing gradualism generally include Vietnam, South Korea, and China. Given the drastic differences

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[9] Ibid.

[10] Ibid.

[11] Ibid.

[12] Asad Alam, et al. *Unleashing Prosperity: Productivity Growth in Eastern Europe and the Former Soviet Union*. The World Bank, 2008: 42

[13] Barry Naughton. *Growing out of the Plan: Chinese Economic Reform, 1978-1993*. (Cambridge Univ. Press, Cambridge, 2010).

between these two approaches, the merits and detriments of both have been thoroughly debated from both an economic, political, and social standpoint throughout academic literature.[14]

First championed by Jeffery Sachs as a method of economic liberalization and growth for Poland, the rapid approach towards economic transformation contends that action should be "as rapid as possible on all fronts."[15] Consequently, under this framework, economic growth and transition models involve rapid, often near-immediate transitions from central planning to market-forces. Mass privatization efforts are focused on the creation and protection of private property, privatization of industrial enterprises, and the cultivation of a wide-spread market economy.[16] The combination of the theory and policy proposals put forth by various economists concerning rapid economic liberalization culminated in the formation of a doctrine of economic transformation commonly referred to as the Washington Consensus.[17] While subscribers to the Washington Consensus such as Sachs believe that "society accepts the need for change and is ready to slough off the brutality and artificiality of the communist system," they caution against the application of an apolitical approach to economic transitions.[18] In fact, Sachs states that, "the hardest part of the transformation, in fact, will not be the economics at all, but the politics".[19]

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[14] Barry Naughton. *Growing out of the Plan: Chinese Economic Reform, 1978-1993*. (Cambridge Univ. Press, Cambridge, 2010).

Jeffrey Sachs. "*Poland's Jump to the Market Economy*, (Cambridge, MA: MIT Press 1999)

Minxin Pei. *China's Trapped Transition: the Limits of Developmental Autocracy*. (Harvard University Press: Cambridge, 2008)

[15] Jeffrey Sachs. "Series Forward." in *Poland's Jump to the Market Economy*, (Cambridge, MA: MIT Press 1999).

[16] Jeffrey Sachs. "Preface." in *Poland's Jump to the Market Economy*, (Cambridge, MA: MIT Press 1999): XIII.

[17] John Williamson. "A Short History of the Washington Consensus." *Peterson Institute for International Economics* (2004): 5- 6

[18] Ibid.

[19] Jeffrey Sachs. "*Poland's Jump to the Market Economy*, (Cambridge, MA: MIT Press 1999): 3

However, within this, he concedes that, “we should expect political turmoil with or without economic reform,” thereby implying that economic liberalization is not the driver of political instability.[20]

While subscribers to the rapid school of thought contended that this violence was unavoidable and that the rapid implementation of market-forces constituted the best overall plan for economic transformation, others, including Martin L. Weitzman and Barry Naughton contend that a gradual, incremented transition is better from an economic, social, and political perspective. While the gradualist approach gained prominence in academic and development circles following the failures of rapid economic transitions in Latin America and Russia, the key components of the approach were first implemented in developing Asian countries including Japan and South Korea.[21] The culmination of these policy measures is commonly referred to as either the BeST Consensus or the Beijing Consensus, in reference to the success of China, South Korea, and Japan under gradualist economic transition policies. The Consensus includes two principal agents: the creation of firms and capacity building and the creation of pilot agencies to guide industrialization.[22] In addition to these two agents, the BeST Consensus advocates for facilitating capability enhancement through targeting and upgrading, and creating an economic environment in which capability development can be continued, through education and the gradual phasing out of non-market interventions.[23] Significantly, unlike shock transition, which advocates for the timely creation and protection of property rights, gradualism does not stipulate

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[20] Jeffrey Sachs. “*Poland's Jump to the Market Economy*, (Cambridge, MA: MIT Press 1999): 9

[21] Keun Lee and John A. Mathews. “From Washington Consensus to BeST Consensus for World Development.” *Asian-Pacific Economic Literature*, vol. 24, no. 1 (2010): 91

[22] Ibid.

[23] Ibid.

the inclusion of this requirement, as evidenced by China's lack of property rights to this day. While both the foundations and merits of this difference is debated within transition economics today, the need for property rights is often characterized as a Western conceptualization of capitalist principles that case-studies of East Asian countries have disproven as fundamental to the successful adoption of other market principles..[24]

Subsequently, given both the size of China's population and economy as well as the trajectory of its growth since the death of Mao, the Chinese approach to gradualist economic transitions has been well documented by economists and political scientists.[25] For many scholars, including Minxin Pei, this analysis is often centered on the limits of a capitalist market under a party-state founded upon Leninist principles.[26] For example, Pei contends that, "the combination of the unresolved contradictions, fundamental to China's transition away from communism, are the source of rising tensions in the Chinese polity, economy, and society."[27] This sentiment is echoed in more recent commentaries on the state of both the Chinese economy and state, as scholars question the seemingly inherent contradiction between a free market under the control

[24] Martin L. Weitzman. "Economic Transition: Can Theory Help? ." *European Economic Review*, 37 (1993): 554

[25] Barry Naughton. *Growing out of the Plan: Chinese Economic Reform, 1978-1993*. (Cambridge Univ. Press, Cambridge, 2010).

Giovanni Arrighi. *Adam Smith in Beijing: Lineages of the Twenty-First Century*. (W W Norton & Co Inc, 2009).

Minxin Pei. *China's Trapped Transition: the Limits of Developmental Autocracy*. (Harvard University Press: Cambridge, 2008)

[26] Minxin Pei. *China's Trapped Transition: the Limits of Developmental Autocracy*. (Harvard University Press: Cambridge, 2008): 8

[27] Ibid.

of an authoritarian government, in terms of both economic viability and the protection of Rule of Law measures.[28]

Despite the immense challenges currently facing China, the country's approach towards economic and social growth has undergone a dramatic transition since The Long-March. Under Mao, growth was uneven, characterized by both massive successes and failures as both a weak economy and a weak state. Mao can be credited with the growth of State-Owned Enterprises (SOEs) and with providing a foundation for the initial growth of the Chinese economy in the first period of CCP rule. However, Mao is also responsible for the Great Leap Forward (1958-1961) and the Cultural Revolution (1966-1976), which resulted in the deaths of millions of Chinese people at the hands of the government and a period of prolonged domestic turmoil and upending.[29]

In the aftermath of Mao's death and the ending of the Cultural Revolution, China was economically and socially distraught, with a per-capita annual income of less than US$100, and a society lacking formal education, expression of thought, and the technical knowledge needed for growth.[30] Prior to his death, Mao designated Hua Guofeng as his successor, bestowing upon him the leadership titles of Chairman of the Party, Premier of the Government, and Chairman of the

[28] Barry Naughton. "Reform Retreat and Renewal: How Economic Policy Fits into the Political System." *Issues and Studies*, vol. 1, no. 51, Mar. 2015.

Barry Naughton. "Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage." *China Leadership Monitor*, vol. 1, no. 51, 30 Aug. 2016: 1–10.

Ling Li. "The Production of Corruption in China's Courts: Judicial Politics and Decision Making in a One-Party State." *Law and Social Inquiry,* 37, 4. (2012): 848-877.

[29] Yuen Yuen Ang. *How China Escaped the Poverty Trap*. (Cornell University Press, Ithaca, 2016): Kindle Location 298 of 8423.

[30] Ezra F. Vogel "China under Deng Xiaoping's Leadership." *East Asia Forum*, 26 Sept., 2011.

Central Military Commission (CMC).[31] However, following the approval of Deng Xiaoping's "Reform and Opening" plan at the Third Plenum in 1978, Deng, as the Vice Chairman of the Party, Vice Premier of the Government, and Vice Premier of the CMC, was established as the *de facto* leader of the party-state.[32] This perception was reinforced by foreign leaders and media outlets, particularly following Deng's successful restoration of relationships with Japan and the United States during his tenure. A pragmatic leader, Deng drew on observations of the development techniques and trajectories of other countries as a guide for the growth of manufacturing in China.

Deng focused on domestic economic modernization throughout his tenure, listing out four requirements during his State of the Union Address in 1980.[33] The requirements included "a firm and consistent political message, political stability and unity, hard work with a pioneering spirit, and a contingent of officials with both an 'unswerving socialist orientation' and 'professional knowledge and competence."[34] Under the guidance of Deng, reforms were characterized by a balance between increased social liberties, including an greater level of freedom of speech as compared to the Cultural Revolution, improvements and innovation in the manufacturing sector, and a capable bureaucracy under the direction of Mao Zedong Thought.[35]

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[31] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011): 246.

[32] Ibid.

[33] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011): 359 - 360.

[34] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011): 360

[35] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011): 364

Deng was able to remain cognizant of the larger objectives and needs of China, allowing him to navigate conflicts and direct ministries and strengthen both the economy and state.

However, Deng's economic planning deliberately concentrated economic growth and FDI into small sectors of the country. Known as Special Economic Zones (SEZs), these targeted regions grew at much faster rates compared to the central and western provinces, widening the already existing economic and social gap between the coastal and inland regions of China. Under Deng, China remained a planned economy with economic-liberalization on the outskirts.[36] This meant that while China grew, growth was directed and deliberate, leaving some to prosper from the access to more open markets, while others gained little from the economic reforms. Despite these challenges, the Chinese economy strengthened and improved manufacturing and industry, bringing market-engagement to mainland China.

Towards the end of his lifetime, Deng's Southern Tour from January to February of 1992 symbolized not only the tremendous progress that had been achieved under his administration, but also the vast potential for future reforms and growth. While he touted the clear successes of manufacturing and the growth of industry in urban areas, Deng was also keenly aware of the disparity between urban and rural areas, having stated, "some areas can get rich before others."[37] Deng spoke openly about the need for continued economic liberalization and reforms and the political and economic future of China throughout the trip[38] For example, cautioning, "China should maintain vigilance against the right but primarily against the left," Deng's frustration with

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[36] Yuen Yuen Ang. *How China Escaped the Poverty Trap*. (Cornell University Press, Ithaca, 2016): Kindle Location 1960 - 1963 of 8423.

[37] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011): 674

[38] Ibid.

conservatives in Beijing prompted further calls for reform from central party leaders in order to display party continuity.[39] Overall, the tour symbolized for the nation and the world the tremendous progress accomplished by China, but also the continued room for growth.

Deng's legacy on Chinese economic liberalization and growth set a strong foundation for the continued efforts of Jiang Zemin, who officially took over all responsibilities from Deng following the conclusion of the Southern Tour.[40] Jiang served as the Chairman of the CMC, President of the People's Republic of China (PRC), and served alongside Zhu Rongyi, the Vice Premier and later Premier of the PRC following Deng's death in 1998.[41] While Jiang was the official head of state, Zhu was responsible for most of the economic reforms, thus leading the period to be referred as a conjunction of the two rulers.

In response to the Southern Tour, Jiang announced the establishment of a "socialist market economy" within China at the Third Plenum of the 14th Party Congress in November of 1993.[42] This choice of words signified both an addition and departure from the economic policies pursued by Deng. As an addition, the words signified a continued emphasis on market-reforms and a transition of the economy towards a more open, market-friendly environment. However, unlike Deng, who operated a centrally-planned economy with market-reforms as a selective

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[39] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011): 673

[40] Yuen Yuen Ang. *How China Escaped the Poverty Trap*. (Cornell University Press, Ithaca, 2016): (Kindle Locations 1960-1963).

[41] Gary LaMoshi. "The Mystery Behind Zhu's Miracle ." *Asia Times*, 22 Feb. 2003.

[42] Yuen Yuen Ang. *How China Escaped the Poverty Trap*. (Cornell University Press, Ithaca, 2016): (Kindle Locations 1960-1963).

characteristic applicable to certain regions, Jiang framed the country as shifting towards a market-oriented economy, away from direct government intervention and planning efforts.[43]

As a result of this change in policy, local governments were allotted a greater degree of experimentation and flexibility for both economic and social reforms. Within this, Beijing maintained a macro-level control over the implementation of reforms, largely directing industry-wide growth and targeting specific geographic areas and industries for growth. However, local governments were given a wide breadth of discretion over funding sources, project selection and fund allocation. This system resulted initially in a high quantity growth of infrastructure projects throughout China.[44] Given the lack of regulation, enforcement, technical knowledge as well as the rise of corruption, many of these projects were low-quality, but contributed to the continued plus-10% growth throughout the tenure of Jiang and Zhu. These projects, which were complemented in the beginning by a weak local bureaucracy incapable of regulation and in need of funding, contributed to the growth of the success of provinces and other local capacities within the eyes of Beijing.[45] This system of internal clientelism incentivized local governments to produce achievements, if only on paper, in order to gain attention and thus increased funding from Beijing, resulting in misconstrued statistical results and an increase in corruption on a local level.

[43] Ibid.

[44] Ibid.

[45] Ibid.

Despite the challenges of the transition towards a socialist market economy, almost a decade after Deng's Southern Tour, China gained membership in the World Trade Organization (WTO) on December 11, 2001.[46] This entry marked the culmination of fifteen years of domestic reforms, starting in 1986 with China's submission to the General Agreement on Tariffs and Trade (GATT) secretariat permission to act as a contracting partner to GATT, one of the first major steps towards WTO membership.[47] While WTO membership did not signify that China was a market-based economy, it indicated that China had eliminated its central-planning efforts and had implemented market-reforms to the extent of the satisfaction of WTO members. WTO membership spurred increased FDI and trade between China and WTO member nations, contributing to the continued growth of the Chinese manufacturing sector and economy as a whole.[48]

Based upon the success of China's entry into the WTO, Hu Jintao assumed a gradual transfer of power from Jiang Zemin. Taking over as General Secretary of the CPC in 2002, President of the PRC from 2003-2013 and Chairman of the CMC in 2004, Hu's transition into the role of paramount leader was largely viewed by Western observers as a positive measure of progressive state-capacity development. From an economic development perspective, Hu's administration can be divided into three periods: the opening of the economy under the WTO and the continued increase in manufacturing exports, the start of Chinese international investments, and a deeper integration into global supply chains and financial relations.[49] While the economy

[46] World Trade Organization. "WTO Successfully Concludes Negotiations on China's Entry." *World Trade Organization*, 17 Sept. 2011.

[47] Ibid.

[48] Gary LaMoshi. "The Mystery Behind Zhu's Miracle ." *Asia Times*, 22 Feb. 2003.

[49] Kerry Brown. *Hu Jintao: China's Silent Ruler*. (World Scientific Pub., Hackensack, 2012): 80.

continued to grow at dramatic rates throughout Hu's tenure, he was also faced with many of the challenges of rapid, manufacturing-based development, including a rise in environmental, energy and labor problems, as well as the increase in the inequality gap and rural-urban divides.[50]

Under Hu, China solidified its position as a new global manufacturing and economic leader given the increased access of Chinese markets and manufacturing to countries throughout the world as a result of China's WTO membership. In many ways, Hu's approach towards economic development during this period bears strong resemblance to Deng's philosophy of "crossing the river by feeling the stones." For example, Hu emphasized "persist in reform and opening up" during a presentation on the work report at the People's Congress in 2007.[51] Through building upon the work of previous leaders, Hu strived to continue to strengthen and grow Chinese manufacturing opportunities and work in order to increase the reach of Chinese manufacturing on a global scale.

However, unlike Deng who did not specify a goal of the economic liberalization and development policies, Hu emphasized the need to construct a "Moderately Prosperous Society" during a speech at the 18th Party Congress in November of 2012.[52] With the promotion of an end goal for economic development, Hu framed economic development in the context of a beneficial and inclusive goal for China, distributing the success of the coastal regions throughout the country. Rooted in Confucian values, the term signifies a transgression away from a more traditional western conception of the creation of a middle-class society, thus contributing to the

[50] Ibid.

[51] Kerry Brown. *Hu Jintao: China's Silent Ruler*. (World Scientific Pub., Hackensack, 2012): 81.

[52] Hu Jintao. "Hu Jintao's Report at 18th Party Congress." 17 Nov. 2011, Beijing, *18th Party Congress*.

evolution of “socialist market economy.”[53] Hu implemented these changes through greatly expanding and strengthening the role of the bureaucracy, notably through the National Development and Reform Commission and the State Assets Supervisions and Administration Commission.[54] Furthermore, Hu delegated numerous domestic economic development decisions to the Vice Premier, Wen Jiabao.[55] This power distribution strengthened the role of the bureaucracy as a facilitator of economic development, but resulted in a decrease in the role of the paramount leader as a driver of economic progress.

However, in response to the global financial crisis of 2008, Hu retreated to earlier economic approaches, favoring increased state-intervention. Pumping USD$ 600 billion into the economy, Hu refused to expose China’s domestic economy to market forces, favoring state intervention over temporary market corrections.[56] While this decision provided temporary stability to the Chinese economy, it failed to demonstrate to other countries that China was fully willing to transition to a market-based economic structure. Hu’s response to the external global financial crisis, as well as similar responses to domestic crisis during his tenure signal a shift towards state-intervention and economic control in order to ensure stability over natural growth and recession periods characteristic of a market-based economy.

Following the recovery and continued growth of the economy after the global financial recession, Hu Jintao completed his second-term at the end of 2012, transitioning power to Xi

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[53] Kerry Brown. *Hu Jintao: China's Silent Ruler*. (World Scientific Pub., Hackensack, 2012): 81.

[54] Barry Naughton. “Reform Retreat and Renewal: How Economic Policy Fits into the Political System.” *Issues and Studies*, vol. 1, no. 51, Mar. 2015: 42.

[55] Barry Naughton. “Reform Retreat and Renewal: How Economic Policy Fits into the Political System.” *Issues and Studies*, vol. 1, no. 51, Mar. 2015: 35.

[56] Kerry Brown. *Hu Jintao: China's Silent Ruler*. (World Scientific Pub., Hackensack, 2012): 96.

Jinping. While Hu's power transition was structured and regimented, Xi assumed all positions, as the General Secretary of the CPC, President of the PRC, and Chairman of the CMC simultaneously in late 2014. Additionally, in October of 2016, at the Chinese Communist Party's Central Committee meeting, the CPC with Xi at the helm, declared Xi as the 'Core Leader.'[57] While the recent change bears no formal change in responsibility, the addition elevates Xi's personal prominence within the party-state to a level not seen since Mao.

The differences between the transition from Jiang to Hu and from Hu to Xi Jinping is in many ways indicative of the many larger differences between Hu and Xi. In fact, many of Xi's political maneuvers and economic platforms appear to act as a correction to the economic and political liberalization policies implemented under Hu. Perhaps the most striking aspect of Xi's administration is the transfer of control over economic decision making back into the hands of the paramount leader.[58] Unlike Hu, who delegated domestic economic reforms to Wen Jiabao, Xi is the clear commander of China's economy, as emphasized by both his definitive leadership positions on committees, high level of media presence, and frequent speeches on the state and future of the Chinese economy.[59] In a similar manner, Xi has altered the political mechanisms for economic reform through creating new CPC Leading Small Groups (LSG), notably the LSG for the Comprehensive Deepening of Reform at the Third Plenum.[60] However, unlike previous LSGs, the LSG for the Comprehensive Deepening of Reform is responsible for the design,

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[57] Chris Buckley. "China's Communist Party Declares Xi Jinping 'Core' Leader." *The New York Times*, 27 Oct. 2016.

[58] Barry Naughton. "Reform Retreat and Renewal: How Economic Policy Fits into the Political System." *Issues and Studies*, vol. 1, no. 51, Mar. 2015: 43.

[59] Ibid.

[60] Ibid.

coordination, and implementation of the reform process, thus significantly expanding the role and powers of Xi's self-selected committee members.[61] Among the proposed changes, Xi has emphasized the need for supply-side structural reform, scientific innovation, and service-sector opportunities.[62]

While it is too early to comprehensively evaluate the impact of many of the specified economic and social policies proposed by Xi Jinping, this thesis aims to evaluate what the impact of both Xi's and previous leaders decisions on the slowing of the Chinese economy. As provided by the literature review and historical overview of the trajectory of the transitioning of the Chinese economy from a state-planning methodology to more market-oriented principles, while the Chinese economy today has integrated market-forces, this has occurred under the ultimate direction and control of the state. The framing of an economic question within the context of the role of the state and impact of political actors and institutional systems makes sense provided the active role that the Chinese state continues to play. While this mode of analysis may not be necessary for economies that are directed by market forces, the limited role of market forces in the direction of macro-economic policy makes the role of the state a needed viewpoint for consideration. As the following hypotheses will highlight, these policies and changes impact economic growth in a myriad of differing ways.

Within the first hypothesis, corruption, the growth, extent and effects of corruption in China on economic growth are examined. Given the inherently hidden and concealed nature of corruption, this hypothesis relies primarily on secondary materials as well as an examination of

[61] Barry Naughton. "Reform Retreat and Renewal: How Economic Policy Fits into the Political System." *Issues and Studies*, vol. 1, no. 51, Mar. 2015: 44.

[62] Barry Naughton. "Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage." *China Leadership Monitor*, vol. 1, no. 51, 30 Aug. 2016: 1–10.

the connections between those prosecuted, particularly within SOEs in order to determine if corruption did in fact have a detrimental impact on economic growth. Subsequently, the first hypothesis postulates that corruption has become rampant in China, leaving the bureaucracies ineffective and stifling economic growth throughout the country.

The second hypothesis, statism, addresses the theory that the state is ineffectively involved in the economy, impeding economic growth. This hypotheses examines the measures taken by Hu Jintao and Xi Jinping to direct the economy, particularly during times of when market forces would traditionally dictate a recession. Additionally, this hypotheses also examines the role of the bureaucracy on a local level in facilitating or hampering economic growth through project and resource allocation. Based upon this channel of analysis, this hypothesis argues that the Chinese party-state is favoring public over private enterprises, thereby impeding the development of an efficient, market-based economy and preventing potential growth.

The final hypothesis, transitional rut, arises out of two beliefs. The first, is that the Chinese model of input-driven and factory based economic growth no longer works for the Chinese economy given the demographic changes undergone by the Chinese population over the past thirty years. Second, the party-state is stuck on a mode of path-dependency and has been unable to transition the economy into a more advanced and diversified model of economic growth. Consequently, the final hypotheses postulates that the party-state is unable to transition the Chinese economy out of a input-driven growth model, causing a slowdown in economic growth.

Following the presentation and analysis of the validity of each of the contesting hypothesis, this thesis will conclude with an examination of the ways in which the factors presented in each of the hypotheses interact and impact one another as well as the slowing of Chinese economic growth. Based upon the culminating impact of these factors, the chapter will offer a predictive segment on both the direction of the Chinese economy as well as the future of economic growth for the country. This predictive segment will highlight both the challenges and opportunities facing China, and how the choices of Xi Jinping and the party-state will impact the trajectory of potential outcomes.

Chapter II

Corruption has become rampant in China, leaving the bureaucracy ineffective and stifling economic growth throughout the country.

Chapter II

Conventional academic literature is divided on the impact of corruption on economic growth. The conventional wisdom, that corruption has a detrimental impact on economic growth, has been documented extensively in developing countries such as Nigeria.[63] However, others have contested that in China and other East Asian countries, corruption has been demonstrated to have aided in economic growth.[64] Therefore, based upon this demonstrated historical precedent of the positive impact of corruption on economic growth in China, the first hypothesis, which analyzes the extent to which corruption has had a detrimental impact on economic growth in China, may seem unnecessary given the longevity and trajectory of China's economic growth over the past thirty years.

Motivated by both the slowing of Chinese GDP growth since 2012 as well as the coinciding initiation and intensity of Xi Jinping's anti-corruption campaign, this hypothesis will re-examine the impact of corruption on the growth of the Chinese economy. However, this analysis will not contest existing academic literature that demonstrates the correlation between corruption and economic growth within China. This analysis will lead to either one of two conclusions. The first states that corruption continues to aid in economic growth, and that Xi Jinping's anti-corruption campaign is therefore an impediment to growth in the short-term. However, the second concludes that corruption has run rampant, weakening the state and stifling economic growth, and that Xi's campaign is attempting to create a cleaner, more efficient bureaucracy free of corruption. This analysis will begin with an examination of existing

[63] Kwabena Gyimah-Brempong and Samaria Munoz De Gyimah-Brempong. "Corruption, Growth, and Income Distribution: Are There Regional Differences?" *Economics of Governance*, 7(3) (2006): 245–269.

[64] Ibid.

academic literature pertaining to the function and impact of corruption on economic growth broadly, in relation to East Asia, and specifically in regards to China. This comparative and historical examination will be followed by an analysis of the recent relationship between corruption and economic growth in China as well as the motivations and impact of Xi's anti-corruption campaign.

While broadly defined as "the use of public office for private gains," existing academic literature divides the targets of corruption into three distinctive categories.[65] The first, political, or grand corruption, is defined as corruption by the highest political decision makers. Political corruption usually involves relatively large bribes that are used to influence policy outcomes or to win contracts.[66] The second and third types, bureaucratic and judicial corruption, concern corruption by bureaucrats or judicial officials involving the coercion of the decision making process by non-government actors in regards to the implementation of existing policies.[67] Examples of judicial corruption include judges taking bribes in return for a favorable decision in a case or the reduction of a sentence. For public officials, corruption may involve taking additional payments beyond the scope of an outlined cost from government contractors, or requiring payments for services where a fee is not legally mandated.

For each of these types of corruption, the relationship between the state actor and the civilian is based upon the civilian providing money or some other gift of monetary value such as luxury items or expensive meals in exchange for the promise of favored service or special

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[65] Barchan, P (1997) as quoted in Mushfiq Swaleheen. "Economic growth with endogenous corruption: an empirical study" *Public Choice* 146 (2011): 23.

[66] Mushfiq Swaleheen. "Economic growth with endogenous corruption: an empirical study" *Public Choice* 146 (2011): 23.

[67] Ibid.

accommodations on behalf of the state actor.[68] While corruption can be *quid pro quo,* it is often manifested through gifts or favors. However, due to the deliberately *sub rosa* nature of corruption, both these exchanges and their corresponding impact on political decisions or economic growth are often difficult or impossible to track. Unlike official legal agreements in which two or more parties sign a contract that legally binds them to the terms of the agreement, the inherent nature of corruption bypasses all formalized and tangible agreements. Subsequently, the examination of the effects and extent of corruption is often based upon the potentially biased perceptions of individual actors within the system, and not upon non-partisan and non-biased economic indicators.

However, within the analysis of the impact of corruption on economic growth across various regions, both the size of the economy and the strength of the bureaucracy for an economy have been documented to have an impact on both the perceptions and effects of corruption.[69] Perceptions of corruption are highly correlated with the strength of a state, as weak states and less capable bureaucracies are more likely to have higher perceived levels of corruption.[70] Therefore, countries with a weak state are more likely to have disproportionately higher levels of perceived corruption compared to states that may actually have similar levels of corruption, but have a stronger state apparatus.[71] Furthermore, the impact of corruption in a particular country has been documented to depend on both the utilization of corruption by

[68] Ibid.

[69] Organization for Economic Cooperation and Development. “Issues Paper on Corruption and Economic Growth.” (2013): 1–43.

[70] Ibid.

[71] Ibid.

individual or group actors.[72] When corrupt officials work as independent monopolists driven exclusively by their own self-interest, the perception of corruption is higher and output is driven down to a lower level, resulting in a detrimental impact on economic growth.[73] However, when public officials work together as a multi-plant monopolist, the total number of bribes sought is smaller, and therefore the perception of corruption is lower and the loss of output is smaller.[74]

In a similar manner, the size of an economy has been demonstrated to have a significant impact on the domestic effect of corruption. For example, the growth-reducing effect of corruption is larger for countries with a low-level of human capital, meaning that countries with a weaker economy are more detrimentally impacted by corruption compared to more economically advanced countries.[75] Subsequently, for weak states in which the state-apparatus is patrimonial and not autonomous, corruption is more likely to have a larger detrimental impact on growth. Similarly, researchers have documented the effect of corruption on the growth rate of real-per-capita income at a statistically significant level.[76] This impact is detrimental to the growth of per-capita income and directly correlated to the strength and persistence of corruption in a given country.[77] Corruption has also been found to slow growth and lead to inefficient

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[72] A. Shleifer and R. W. Vishny. "Corruption." *The Quarterly Journal of Economics* 108(3) (1993): 599–617.

[73] Ibid.

[74] Ibid.

[75] Isaac Ehrlich and Francis Lui. "Bureaucratic Corruption and Endogenous Economic Growth." *Journal of Political Economy* 107(6) (Dec. 1999): S270–S293.

[76] Ibid.

[77] Isaac Ehrlich and Francis Lui. "Bureaucratic Corruption and Endogenous Economic Growth." *Journal of Political Economy* 107(6) (Dec. 1999): S278.

investments in public projects, along with a decrease in the amount of foreign investment for countries with higher levels of perceived corruption.[78]

Finally, researchers have discovered statistically significant regional differences in the effects of corruption on economic growth and income distribution.[79] Corruption has been found to have the lowest growth impact for OECD member and Asian countries, with African countries having the highest growth impact. For both OECD and Asian countries, a 10% decrease in corruption was found to contribute to an income growth of 1.7%, compared to an increase of 2.6% in Latin American countries and 2.8% in African countries for the same degree of reduction.[80] Thus, the impact of corruption on the economic growth of a particular country is highly dependent on both the strength of both the domestic economy and bureaucracy. In this manner, corruption has had less of a detrimental impact on growth in stronger states, as corruption is operationalized within an institutional system that has the ability to constrain the impact of corruption on the state given the size, structure, and construction of the state institutions.

Despite the fact that the countries and territories commonly included in regional comparative examinations of corruption in East Asia, including Taiwan, South Korea, China, and Singapore, have vast disparities in the size and characteristics of their own economies, the countries and territories are frequently compared due to the similarities in the growth trajectories between the two countries in the post-WWII era. For example, researchers have established a

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[78] Ahmen Audu Maiyaki. “The effects of corruption on the Nigerian economy.” *Business Review* 5(2)(2010): 111-126. Web. 30. Nov. 2015.

[79] Kwabena Gyimah-Brempong and Samaria Munoz De Gyimah-Brempong. “Corruption, Growth, and Income Distribution: Are There Regional Differences?” *Economics of Governance*, 7(3) (2006): 245–269.

[80] Ibid.

positive causality between corruption and economic growth for South Korea and China, meaning that corruption has aided, not hampered economic growth.[81] For these economies, corruption has been found to be effective in 'greasing the wheels' in the facilitation of economic growth on both a local and national level.[82] Furthermore, academic research indicates that within China, an increase in economic growth has coincided with an increase in corruption, implying that while corruption has fueled growth in China, this economic growth has also supported the growth of corruption.[83]

Research suggests that corruption yielded growth in these states because it occurred within the context of a state system that was made stronger through initial anti-corruption efforts.[84] For example, in both Singapore and Hong Kong (while still a colony of the United Kingdom), the successful implementation of anti-corruption campaigns while the states were still relatively poor corresponded with a significant subsequent growth in GDP.[85] This same trajectory can be seen in mainland China, as Deng Xiaoping simultaneously strengthened the state and the economy, starting China's three-decade period of prolonged plus-10% GDP growth.[86] Therefore, while corruption has been demonstrated to yield economic growth in East Asia, this growth occurs within a system that is strong, and is thus not hampered by corruption in the same manner

[81] Chiung-Ju Huang. "Is Corruption Bad for Economic Growth? Evidence from Asia-Pacific Countries." *The North American Journal of Economics and Finance* 35 (2016): 247–256.

[82] Ibid.

[83] Ibid.

[84] Organization for Economic Cooperation and Development. "Issues Paper on Corruption and Economic Growth." (2013): 4.

[85] Ibid.

[86] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011).

that states with a weaker bureaucracy are affected. However, widespread use of corruption as a means of economic growth within these countries suggests that subsequent anti-corruption efforts may have not been as effective given the proven beneficial nature of corruption in greasing the wheels, along with the presumption that corruption does not weaken the state.

Within China, corruption most commonly operates through the utilization of an individuals *guanxi* network. Defined generally as "connections," *guanxi* literally means "relation" or "relationship," although it is more commonly referred to as "particularistic ties."[87] The sum of one's *guanxi* relationships comprises his or her *guanxi* network, with the sum of *guanxi* networks in society forming a system of interconnected informal relationships. *Guanxi* relationships must be constantly cultivated and maintained overtime, even if the relationship itself is naturally occurring, such as a familial connection.[88] The relationships are normally formed based upon a shared commonality between two individuals, such as a common *alma matter*, hometown, interest, or employment experience.[89] These connections blur the line between personal relationships and professional titles, allowing personal motivations and relationships to impact the ways in which the state and economic actors interact on both a local and national level.

While corruption commonly operates through the utilization of *guanxi* networks, the networks and connections themselves are not inherently corrupt; therefore while corruption can

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[87] Jacobs (1979, 1980) as qtd. in Thomas Gold, Doug Guthrie, and David L. Wank. *Social Connections in China: Institutions, Culture, and the Changing Nature of Guanxi.* (Cambridge UP, Cambridge, U.K., 2002): 4

[88] Kipnis (1997); Yan (1996a); Yang (1994) as qtd. in Thomas Gold, Doug Guthrie, and David L. Wank. *Social Connections in China: Institutions, Culture, and the Changing Nature of Guanxi.* (Cambridge UP, Cambridge, U.K., 2002): 6

[89] Thomas Gold, Doug Guthrie, and David L. Wank. *Social Connections in China: Institutions, Culture, and the Changing Nature of Guanxi.* (Cambridge UP, Cambridge, U.K., 2002): 6.

stem from *guanxi* connections, not all *guanxi* connections lead to corruption. Through *guanxi* connections local public officials and business leaders influence can influence the process of economic growth, as an individual's *guanxi* network can be utilized to direct investment to both localities or individual projects.[90] Consequently, if the utilization of *guanxi* networks throughout the party-state had a detrimental impact to the point in which it lowered output and slowed economic growth, one would expect to see a continual inverse relationship between GDP growth and perceived levels of corruption. However, if the utilization of *guanxi* networks did not have a detrimental impact on output and GDP growth, there would be an observed relationship between corruption and GDP growth.

In order to determine the impact of corruption on the slowing of the Chinese economy, this thesis examines the recent relationship between corruption and GDP growth, the results of which are displayed in Figures 2.1 and 2.2.[91] The data points on the graph were compiled from both the World Bank for GDP and Transparency International's Corruption Perception Index (CPI) for perceptions of corruption. The World Bank does not have data for China on transparency, accountability and corruption in the public sector. Therefore, Transparency International's CPI database is the most comprehensive available dataset for perceptions of corruption within China. Compiled annually, the CPI currently ranks countries on a scale from 0 - 100 based upon perceptions of the level of corruption within a country's public sector. The perceptions for individual countries are compiled through a series for surveys from relevant country experts, business corporations, government agencies, and executives of multi-national

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[90] Ibid.

[91] Transparency International. "Corruption Perception Index." *Transparency International* (2016)
The World Bank. "GDP Growth (Annual %)." *The World Bank.*

corporations. However, given the reliance exclusively on an individual's subjective opinions of corruption for methodology, the survey is highly susceptible to influence from intervening factors that may impact an individual's own perception of corruption within their experiences. Furthermore, in 2012, CPI changed its index rankings, switching from a ranking system based out of 10 to one based out of 100, making a conversion and direct comparison between the two impossible and resulting in the division of data before and after 2012.[92] For the purposes of this analysis, data for GDP growth and CPI index rankings was compiled for the period of time ranging from 2009-2015 in order to accommodate a comparison of the anti-corruption efforts pursued by Hu Jintao as well as to provide a larger perspective on the economic growth and CPI index beyond the immediate potential impact of corruption during Xi Jinping's administration.

Figure 2.1

[92] Personal email correspondence, CPI Institute, Transparency International. December 2016.

Figure 2.2

The results presented in Figures 2.1 and 2.2 indicate that an inverse relationship between the level of perceived corruption and economic development exists for the period from 2009 - 2011 during Hu Jintao's tenure. However, there is no sustained correlation between perceived level of corruption and economic growth for the period ranging from 2012 - 2015 when Xi Jinping assumed control. For this period, the CPI measurement for China deceased and then increased, while the Chinese GDP continuously decreased. Therefore, the evidence does not immediately support the hypotheses that corruption in China has run rampant and stifled economic growth, as the perceived level of corruption does not continue to inversely correspond to a change in GDP.[93] However, given the inverse relationship for the period from 2009-2012, corruption could have played an impact on the developmental trajectory of the Chinese economy during this period. Further, while this empirical analysis provides evidence for the correlation between corruption and economic growth within China, it does not prove that corruption impacted economic growth. Overall, the lack of a continuous inverse correlation between CPI rankings and GDP growth does not indicate that corruption had enough of a demonstrable impact on economic growth to explain such a dramatic and prolonged slowing of growth, making the data for this comparison largely inconclusive.

However, recent findings suggest that while corruption has previously aided in the economic growth of China, as the economy and bureaucracy evolved and expanded tangentially, corruption transgressed from a contributing factor of progress to an impediment, as the benefits of 'greasing the wheels' no longer coincided with the structure of the advanced bureaucracy.[94] While the social capital provided through *guanxi* networks is initially conducive towards facilitating growth, as the both the economy and bureaucracy grow and develop, corruption has appeared to become an impediment to further economic growth within China.[95] In this manner, corruption, combined with weak institutions, can be seen as beneficial to facilitating economic growth, but is an impediment to maintaining growth.[96]

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93 Within this analysis it is important to note that the change in methodology and measurement on behalf of Transparency International could have also contributed to this change in perceived levels of corruption.

94 Yuen Yuen Ang. *How China Escaped the Poverty Trap*. (Cornell University Press, Ithaca, 2016): (Kindle Location 2983).

95 Ibid.

96 Ibid.

As previously discussed in the first chapter, the growth of the Chinese economy has largely been possible due to the high degree of experimentation allotted to local governments. While these policy goals include tangible targets for growth, the central party-state has traditionally restrained from providing specified directives on appropriate methods and programs to achieve growth. More recently, in order to target a myriad of growth measures, the central party-state has appointed high-level party-state officials to Leading Small Groups (LSGs) to direct sweeping goals for economic development.[97] However local governments continue to be allotted a high degree of experimentation and discretion for policy implementation. While this system allows local governments to best define relevant policies for their unique economies, a system of localized control over the implementation of overarching goals is highly susceptible to corruption.

For instance, because Beijing is often solely concerned on the output and completion of goals on a local level, both local state and business actors are incentivized to utilize their own *guanxi* networks in order to implement initiatives that fuel growth and mutually benefit both the business and state actor. In this manner, the system of localized discretion and control provides the incentive for corrupt practices, while *guanxi* networks provide the means for this corruption to take place. Consequently, only the high-level officials within the party-state have a motivation to reduce corruption, as the mid and lower-level officials benefit from systems of corruption through *guanxi* networks, and do not have an immediate benefit to stopping the continuation of corrupt practices.

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[97] Barry Naughton. “'Deepening reform': The organization and emerging strategy.” *China Leadership Monitor* 44 (2014): 1-14.

For example, in order to facilitate the growing need for urban land, local government officials in Chongqing and Chengdu improvised a system of land-swaps, in which land delegated as rural was converted into urban land in exchange for the preservation of other tracts of rural land.[98] Known as the *dipiao* system, the program allowed for the rapid urbanization and growth of Chongqing as a major industrial center within central China. In theory, the land-owning famers who traded in their land designation, swapping the title of the land from rural to urban, were supposed to receive 85% of the proceeds of the land sales, with the remaining 15% going towards the local Town and Village Enterprise (TVE).[99] The TVE was then supposed to use this revenue to invest within the community; however, corrupt influences often times diverted the flow of these funds, extracting payments from farmers and the TVE.[100] Consequently, the integration of corruption into the system relied heavily on the utilization of the individual *guanxi* networks of both local officials and entrepreneurs to identify farmers to target for the land-swaps and direct the money through the appropriate channels within the party-state to ensure that it reached the hands of others outside of the TVE. The culmination of these influences resulted in a high-degree of corruption for the *dipiao* system, as facilitated by the utilization of *guanxi* networks. However, perceiving the corruption resulting from the *dipiao* system as both a threat to state-control and legitimization as well as ineffective method of economic growth, the central party-state subsequently banned the *dipiao* system.[101]

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[98] Tom Miller. *China's Urban Billion: The Story behind the Biggest Migration in Human History*. Zed Publishing, London 2012): 82.

[99] Ibid.

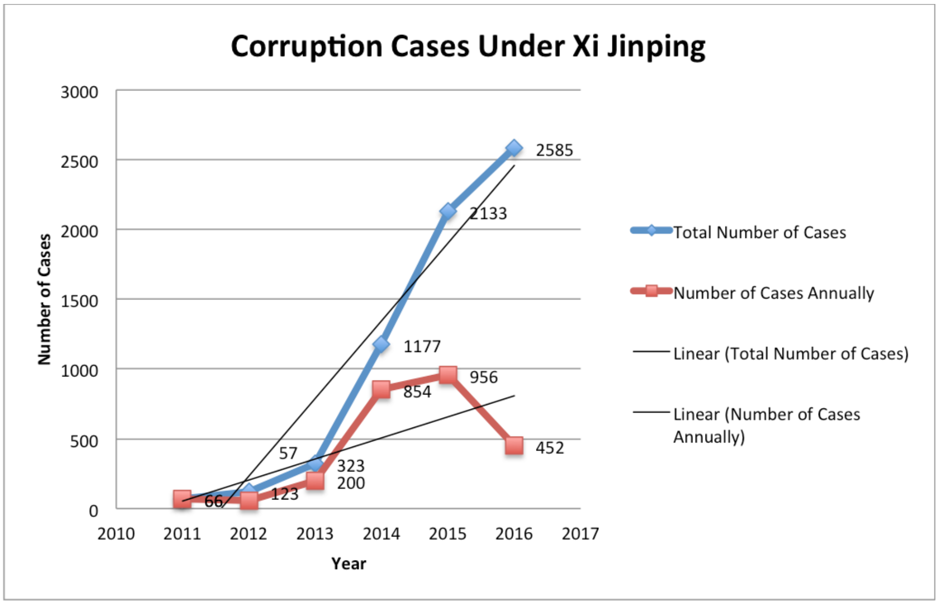
[100] Ibid.

[101] Ibid.

Through the combination of both the comparison of GDP growth with CPI indicators as well as existing academic literature on the impact of corruption on economic growth within China, it is clear that institutions of corruption such as the *dipiao* system that were orchestrated and implemented under Hu Jintao diminished the strength of the bureaucracy through the utilization of processes that fueled corruption through local discretion supervised only by a results-focused central state. In this manner, the weakened state made corruption not only more visible, but impacted economic growth due to the inability of the state to counteract the corrosive aspects of corruption due to the reliance on systems of local control with little overarching oversight. Further, in this instance the state has encountered a rut, as corruption is no longer beneficial to growth, but the state also appears unable to rid the bureaucracy of corrupt influences. However, because the CPI changed by only 0.1 points prior to 2012 and by 3 points after 2012, it appears unlikely that such a small change in the levels of corruption could have such a dramatic impact on economic growth as to constitute a comprehensive answer as to why the Chinese economy has slowed. Thus, while corruption can be said to have impacted the slowing of the Chinese economy, it cannot serve as the primary explanation as to why economic growth has slowed.

Despite this conclusion, the size and scope of Xi's Anti-Corruption campaign merits further investigation into the motivations as to why Xi would continue to frame corruption as having such a decisive impact on the slowing of the Chinese economy, if research indicates that corruption cannot serve as the primary explanation for why the Chinese economy has slowed. Since its inception in 2010, a total of 2,585 officials have been investigated, with those sentenced

Figure 2.3



accounting for the embezzlement or extortion of ¥7,307,211,015 CNY (USD$1,056,810,581).[102] Within this, 289 are Tigers, ranking above the level Deputy Provincial or Vice Ministerial level for party and government officials, or above the Major General ranking for the military. The remaining 2,246 are Flies, defined as lower level party, government, or military officials.[103] As illustrated by Figure 2.4, the majority of the cases investigated involve Flies, with the majority of cases leading to sentences or expulsions and arrests.[104] Officials were dispersed across a variety of sectors, ranging from SOEs, banking, construction, and medicine.[105]

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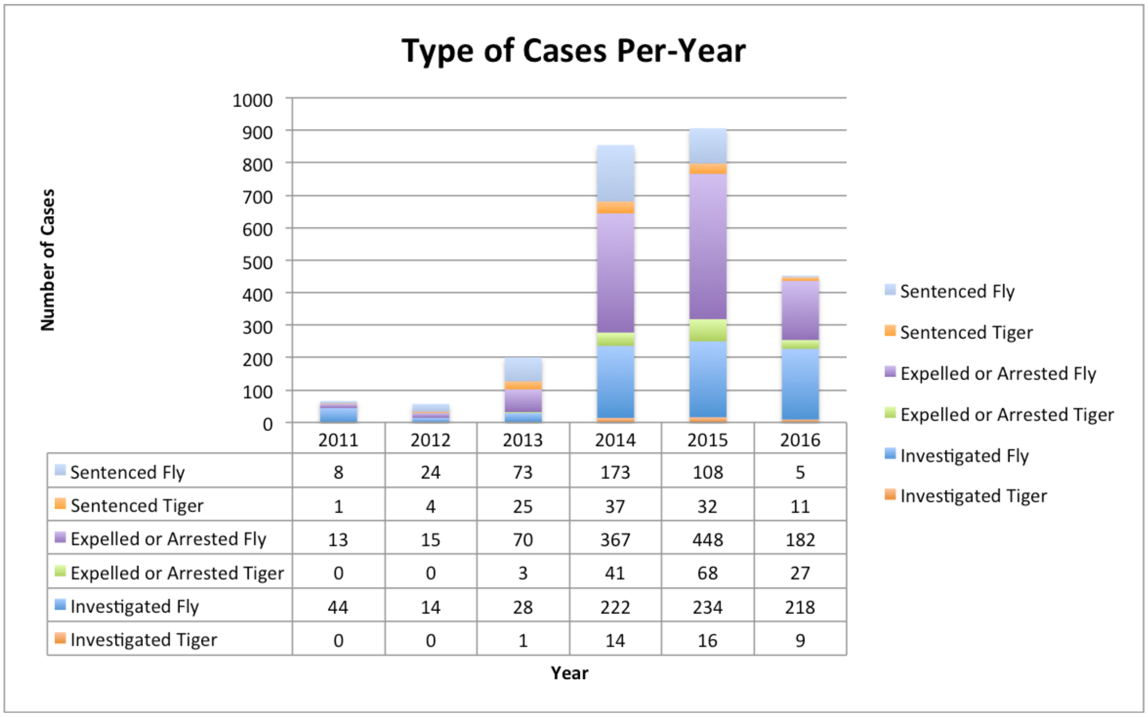
[102] David M. Barreda, et al. "Visualizing China's Anti-Corruption Campaign." *ChinaFile*, Center on U.S.-China Relations at Asia Society (21 Jan. 2016).

[103] Ibid.

[104] Sentences are defined as cases in which individuals who have been tried in a Chinese court have been found guilty. Expelled and arrested is defined as cases in which individuals have been expelled from the party and/or indicted, and includes hose that were apprehended overseas and brought back to China. Investigated individuals signifies cases that are under investigation by the CCDI, and are often classified as 'serious violations of discipline.' All cases are categorized by the most recent charge.

[105] Ibid.

Figure 2.4



	2011	2012	2013	2014	2015	2016
Sentenced Fly	8	24	73	173	108	5
Sentenced Tiger	1	4	25	37	32	11
Expelled or Arrested Fly	13	15	70	367	448	182
Expelled or Arrested Tiger	0	0	3	41	68	27
Investigated Fly	44	14	28	222	234	218
Investigated Tiger	0	0	1	14	16	9

Despite the power of the campaign, it isn't all encompassing— only targeting 5.78% of officials above the Vice Ministerial level.[106] However, the campaign has significantly strengthened both the soft-power and influence of Xi Jinping throughout the party-state. Running the campaign through the Central Commission for Discipline Inspection (CCDI), the campaign has targeted political enemies of Xi, as evidenced by the disproportional targeting of Guangdong, Henan, and Shanxi— the strongholds of Hu Jintao and his former top aide, Ling Jihua, particularly when compared to the more lenient sentences given to officials from Fujian and Zhejiang, the provinces previously led by Xi Jinping.[107]

[106] Ibid.

[107] Ibid.

Furthermore, at the Sixth Plenum of the 18th Communist Party of China (CCP) Central Committee held in October of 2016, the party unanimously approved an update to the 1980 document, "Rules on Intra-Party Political Life" and introduced the "Regulations on Intra-Party Supervision."[108] Combined, the documents strengthened both the investigative jurisdiction of the CCDI and implemented more stringent anti-corruption policies, explicitly defined as ""no restricted zones, full coverage and zero tolerance" for all officials.[109] Attendees of the plenum also unanimously voted Xi Jinping as 'Core Leader,' elevating him to a position of soft-power within China not held since Mao. The term has historical significance with Chinese leadership—Deng Xiaoping posthumously delegated Mao as the 'core' leader of Communist China.[110] Since the attempted *coup de état* organized by Mao's last wife, Jiang Qing in the wake of Mao's death, Chinese heads of state have been bound by both legal restrictions and historical precedent against establishing cults of personality as aspects of their power.[111] However, based upon both the demonstrated targeting of political enemies through the corruption campaign, it appears that Xi is changing these established cultural and legal norms in order to heighten his own power both within the party and China as a whole. Therefore, when Xi's anti-corruption campaign is viewed in conjunction with these recent legislative changes to the power afforded to Xi, the campaign appears to be grounded more in his desire to consolidate power and self-image than an effort to truly rid the party-state of corruption.

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[108] Shannon Tiezzi. "Can China Finally Solve Its Corruption Problem?" *The Diplomat*, The Diplomat, (29 Oct. 2016).

[109] Xinhua Daily News. "No Hideout for Corrupt Officials in CPC: Communique." *Xinhua Daily News*, (27 Oct. 2016).

[110] Ben Blanchard and Benjamin Kang Lim. "As China Plenum Opens, Party Paper Says 'Core' Leadership Needed." *Reuters World News*, Thomson Reuters, (24 Oct. 2016).

[111] Ibid.

In conclusion, despite the evidence of the detrimental impact of corruption on GDP growth in China in recent years as it is no longer able to 'grease the wheels' of economic growth, corruption cannot be said to be the most decisive explanation for the slowing of the Chinese economy. This conclusion is based in the lack of evidence of the direct and continued impact of corruption on GDP growth, and the inability of the impact of corruption to serve as a comprehensive framework for the slowing of the economy. If corruption were to have a substantive and widespread impact on the slowing of the Chinese economy, the perception of corruption as measured through the CPI index would be higher and continuously inversely correlated to GDP growth.

Consequently, Xi's anti-corruption campaign appears to have two motivations: to rid the party-state of corruption, but also to consolidate and strengthen the power of Xi Jinping. While the campaign has targeted a wide variety of individuals, given the increase in the perception of corruption in China from 2014 to 2015, the campaign cannot be said to be effective in combating corruption on a widespread level. However, despite the lack of effectiveness in implementing a widespread targeting of corrupt officials throughout the party-state, the campaign is likely strengthening the state through consolidating and increasing the power of the central party-state leadership, which could potentially decrease the impact of corruption. This impact would likely be manifested through the decrease in the number of officials utilizing corrupt practices in order to achieve target growth rates as set by Beijing out of fear or investigation, sentencing, and public humiliation. In this manner, the campaign could be seen as a method of ensuring that the bureaucracy and institutions retain their strength and do not develop patterns of the influence of corruption similar to weaker states.

Therefore, the impact of the weakened state apparatus under Hu Jintao likely led to a greater impact of corruption and thus contributed to the slowing of growth. However, the degree of change for the perception of corruption within this time period is not large enough as to form a conclusive explanation as to why the Chinese economy has enduring slowing growth at the degree it has for an extended period of time. Thus, while corruption likely played a role in the slowing of economic growth, it does not present the most conclusive and comprehensive explanation as to why the Chinese economy has slowed, but is likely a significant contributing factor in the larger institutional structures and issues facing China today.

Chapter III

The Chinese party-state is favoring public over private enterprises, thereby impeding the development of an efficient, market-based economy and preventing potential growth.

Chapter III

As discussed in the first chapter, since the opening of the Chinese economy to Foreign Direct Investment (FDI) through Special Economic Zones (SEZs) under Deng Xiaoping, the trajectory of Chinese economic growth has been characterized as a gradual and regimented process. Unlike countries that utilized the Washington Consensus approach in which market forces and property rights were rapidly enforced, for China under the BeST Consensus the transition from state-planning has been guided by state-actors, not market forces. If the party-state was continuing to productively aid and facilitate the transition to an economy more reliant upon market-forces and away from a system of state-planning, one would expect to see an economy where public enterprises were productive and efficient sectors of the economy. However, despite the incremental steps towards liberalization that began under Deng Xiaoping, it appears that more recently China has been unable to reduce and reform the role of public enterprises within its economy, leading to the emergence and continued state support of inefficient and failing public firms.

Consequently, this chapter addresses the hypothesis that the party-state is favoring public over private enterprises, thereby impeding the development of an efficient, market-based economy. This hypothesis does not examine the degree of liberalization of the economy, but instead whether the role of the party-state is hampering or aiding in economic growth. Furthermore, this hypothesis does not question nor challenge the BeST Consensus approach of gradual and controlled economic transition and liberalization. Rather, this chapter is focused on analyzing if policies of state-guided capitalism under Hu Jintao and Xi Jinping have led to the inefficient allocation of resources and the stifling of economic growth. This analysis will begin with an examination of the historical role of the party-state in fostering economic growth and transitions. This historical overview will be followed by an analysis of the economic impact of recent policies implemented by Hu Jintao and Xi Jinping on both the reform and integration of market-based economic behavior for public enterprises.

Under Mao, both the state apparatus and economy were weak, characterized by periods of instability, starvation, and lack of economic opportunity.[112] While Deng Xiaoping was able to maintain the party loyalty and nationalism cultivated by Mao, he focused on constructive measures to strengthen the state and economy. These measures often operated tangentially, with the state directing economic growth and liberalization policies while simultaneously strengthening the bureaucratic apparatus of the party-state. As highlighted in the first chapter, Deng focused on four tenants of economic modernization throughout his tenure, including "a firm and consistent political message, political stability and unity, hard work with a pioneering spirit, and a contingent of officials with both an 'unswerving socialist orientation' and 'professional knowledge and competence.'"[113]

Through these four tenants, Deng retained and continued to focus on maintaining the stability of SOEs across a variety of sectors, including energy, heavy industry, manufacturing, and transportation.[114] At the same time, the creation of SEZs led to the dramatic growth of FDI into China, yielding in the creation of low-wage, low-skill jobs throughout coastal cities that had

[112] Yuen Yuen Ang. *How China Escaped the Poverty Trap*. (Cornell University Press, Ithaca, 2016): Kindle Location 298 of 8423.

[113] Ezra F. Vogel. *Deng Xiaoping and the Transformation of China*. (Belknap Press of Harvard University Press, Cambridge, 2011): 360

[114] Ibid.

been designated as SEZs.[115] Thus, the Chinese economy operated within a duality of public and private enterprises under the overarching guidance of the state, as foreign investment and the integration of market forces was strictly monitored and controlled. Furthermore, Deng did not attempt during his tenure to reform SOEs, instead choosing to focus exclusively on economic liberalization through alternative means. This was accomplished through the introduction of new mechanisms to introduce market forces, and not through the reform of existing institutions, thus yielding the creation of SEZs and not widespread reforms of SOEs.[116] In fact, the first major attempted wave of privatization for SOEs was not attempted until the mid-1990s under Jiang Zemin.[117]

This duality pattern of public-private growth continued under Jiang Zemin, becoming in many ways a pattern of growth not only under the BeST Consensus model, but a distinctively Chinese style of transition-economic growth. For example, while the spread of FDI beyond SEZs contributed to the growth and liberalization of the Chinese economy as a whole, this growth and subsequent shift occurred under the guidance of the party-state. Throughout this time period, SOEs continued to operate, despite the decreased profitability and productivity of many of the individual firms. Newly introduced plans for the reform of SOEs then focused on both the reduction in size of the public enterprises and a restraint of state interference. But these plans were consistently met with failure, leading to the continued inefficient operation of SOEs

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[115] Ibid.

[116] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. “Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises” *MERICS: Mercator Institute for China Studies* March 2017: 1-11.

[117] Ibid.

throughout China.[118] Although market-forces continued to gain traction throughout the Chinese economy as a whole, this directionality continued to be guided by the party-state, and not market forces.[119] Certain sectors, notably banking, media, and internet-based companies were subject to intense scrutiny, restrictions, and regulations by the party-state, much of which continues today.

Hu Jintao inherited many of the same issues faced by Jiang Zemin, including inefficient SOEs, the need to maintain the balance between the integration of market-forces, and the desire for continued state guidance over the growth and trajectory of the economy. Under his leadership, while growth was rapid and led to the expansion and diversification of both the economy and areas of investment, this positive growth trajectory was largely confined to the private sector, as the public enterprises were unable to achieve positive growth margins.[120] Attempts at privatization reforms or downsizing of the public enterprises by the party-state were unsuccessful, leading to the creation and emergence of zombie firms throughout China. While Xi Jinping has broadly outlined an aggressive strategy of reforms for these zombie firms, it is currently unclear if the initial surface-level aggression of the reforms will translate into effective results.[121] But if Xi is able to implement successful reforms, the consolidation of firms and rationalization of markets should result, leading to the potential dissipation of zombie firms with an increase in productivity and profitability for remaining firms.

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[118] Yuen Yuen Ang. *How China Escaped the Poverty Trap*. (Cornell University Press, Ithaca, 2016): (Kindle Locations 1960-1963).

[119] Ibid.

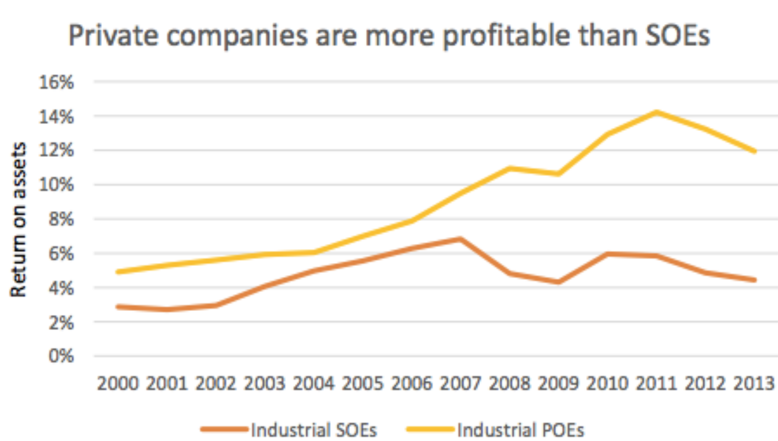
[120] Shiyong Zhao, "Government Policies and Private Enterprise Development in China: 2003-2006." *China & World Economy, 17*(4) (2009): 49.

[121] Barry Naughton, "Reform Retreat and Renewal: How Economic Policy Fits into the Political System." *Issues and Studies,* 1(51), (2015, March): 47.

Given the historical trajectory of the role of SOEs and state guidance over the Chinese economy, while it is clear that the party-state has been unsuccessful in maintaining profitability within SOEs in recent decades, it is unclear to what extent this failure and the approach of the party-state has impacted the recent slowing of the Chinese economy. The second half of this chapter will thus examine both the impact of recent state-guided capitalist policies implemented by the party-state for the public enterprises in an effort to discern if the actions of the party-state in this capacity have impeded economic growth.

When Deng Xiaoping first announced the creation of SEZs in 1978, SOEs accounted for 3/4 of China's industrial output. Today, SOEs are responsible for 1/4 of China's industrial output, with private firms accounting for 90% of the country's exports.[122] As indicated by Figure 3.1, compared to private enterprises, SOEs are generally less profitable and more indebted, despite the generous subsidies and access to credit afforded to the public firms.[123] Likewise, as indicated by Figure 3.2, SOE value added output, even when measured conservatively as a combination for SOEs and State-Holding Enterprises (SHEs), is consistently shrinking as a share of the output of total

Figure 3.1



[122] Nicholas R. Lardy, *Markets over Mao: The rise of private business in China*. (Peterson Institute for International Economics: Washington, DC): 20.

[123] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. "Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises" *MERICS: Mercator Institute for China Studies* March 2017: 3.

Figure 3.2

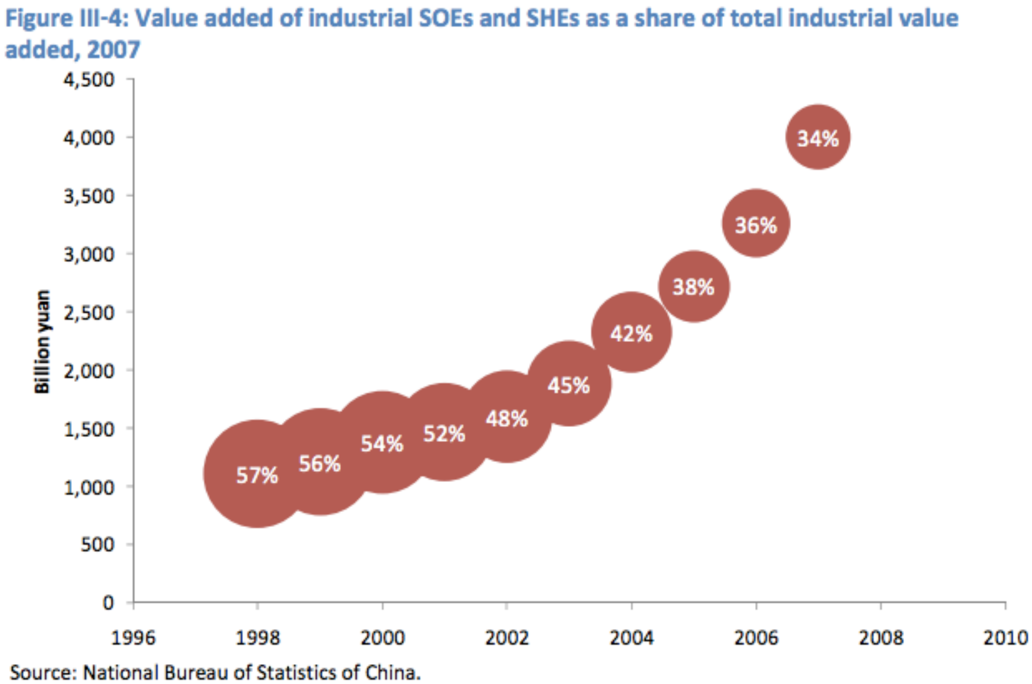
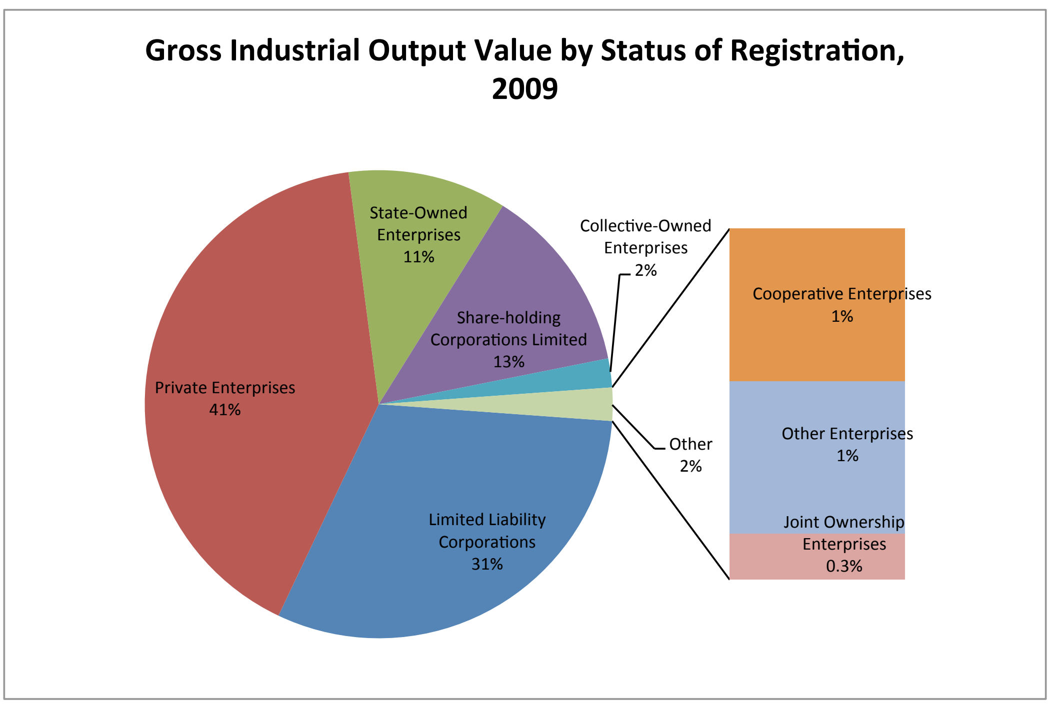


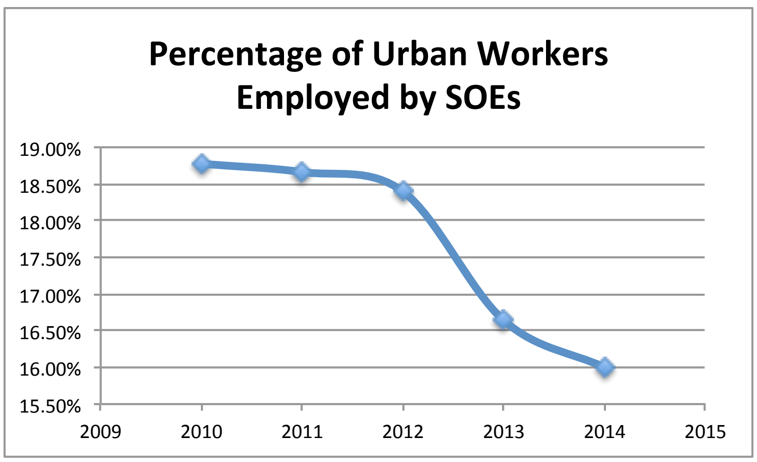
Figure 3.3



industrial value added, meaning that SOEs are contributing less and less to economic growth within the industrial sector, even as the total industrial sector value added continues to rise.[124] While it is highly unlikely that the party-state will ever relinquish state control over certain SOEs, notably utility firms, the overall output of SOEs pales in comparison to the private sector, as indicated by Figure 3.3.[125]

Therefore, despite the differences between types of SOEs in regards to the role of the individual firm within the Chinese economy, SOEs do not contribute in a significant manner to productive output. Further, despite the continued increase in the size of the urban working population, the percentage of urban employees employed at SOEs has declined, as evidenced by Figure 3.4.[126] Subsequently, despite the growth of the Chinese economy, the size and productive growth output of SOEs has decreased.

Figure 3.4



Empirical data suggests that under Hu Jintao, state-owned firms were given preferential treatment compared to private firms.[127] For example, at the beginning of 2004, state-owned firms

[124] Andrew Szamosszegi and Cole Kyle. "An Analysis of State−Owned Enterprises and State Capitalism in China." *U.S.-China Economic and Security Review Commission*. (2011): 14.

[125] Ibid.

[126] National Bureau of Statistics of China. "China Statistical Yearbook 2015." (2016).

[127] Risto Herrala and Yandong Jia. "Toward State Capitalism in China?" *Asian Economic Papers* 14(2) (2015): 172.

had a 'favoritism parameter' of 0.3 for credit availability compared to privately owned firms, meaning that state-owned firms were 0.28 times more likely to gain access to credit compared to private firms. However, by the end of 2011, this parameter had increased to 0.97, indicating an increase in favoritism of state-owned firms over private firms in terms of credit ability.[128] This indicates that state-owned firms were more likely to gain preferential treatment compared to private enterprises when seeking lines of credit from state banks, both locally and nationally. Further evidence indicates that state-owned firms gained increased access to greater lines of credit after the global financial recession of 2008 - 2009, in which the People's Bank of China (PBOC) deliberately released four trillion CNY (USD $586 billion) into the economy in order to counteract the negative effects of the global financial recession and prevent market forces from having a negative effect on GDP growth.[129] For example, the favoritism parameter increased from 0.558 in 2007 to 0.97 in 2011, compared to the increase of 0.28 in 2004 to 0.50 in 2006. This increase in the intensity of the party-state's favoritism parameter after the global financial recession indicates that actors within the party-state directed credit towards the low-growth and failing SOEs in the wake of the financial recession, instead of towards the private firms that both constituted a larger sector of the economy and added more value to the economy.

Despite the favoritism of public firms over private firms for the allocation of credit in the wake of the global financial recession, as indicted by Figure 3.5, the Chinese economy grew, while the rest of the world experienced a recession.[130] However, an analysis of the benefit-to-cost ratio for infrastructure investments in China concerning *ex post* outcomes reveals that while

[128] Ibid.

[129] The Economist. "China Seeks Stimulation." *The Economist*, 10 Nov. 2008.

[130] The World Bank. "GDP Growth (Annual %)." 2016.

Figure 3.5

Annual World and Chinese GDP Growth (%)

Year	2007	2008	2009	2010	2011	2012
China	14.23138804	9.654289373	9.399813171	10.63614046	9.536443008	7.85626211
World	4.320227454	1.843825615	-1.700531493	4.371841631	3.098472905	2.44523353

these projects initially result in a boom, infrastructure investments do not lead to economic growth, and later contributes to economic slowdown.[131] In fact, this over investment in underperforming infrastructure explains in part the slowing of the economy, as the government continues to favor these public firms in the completion of projects and allocation of credit.[132] Besides artificially protecting the Chinese economy from the effects of the global financial recession, this continued access to funds thus indicates that disparities in access to credit between private and state-owned firms under Hu Jintao was structural, not circumstantial in nature, and is representative of a shift away from market-oriented reforms.[133] This is due to the fact that even as the party-state attempted to protect and artificially support the Chinese economy as a whole in the wake of the recession, the capital resources of this supporting guidance were disproportionately and deliberately directed towards public firms over private firms. Therefore, state guided capitalism under Hu Jintao was not focused on the continued transition towards market-based economic growth away from an economic model of state-planning. While this focus contributed to the initial economic boom following the recession, it also contributed towards the subsequent economic slowdown.

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[131] Atif Ansar et al. "Does Infrastructure Investment Lead to Economic Growth or Economic Fragility? Evidence from China." *Oxford Review of Economic Policy*, 32(3) (2016): 360–390.

[132] Ibid.

[133] Risto Herrala and Yandong Jia. "Toward State Capitalism in China?" *Asian Economic Papers* 14(2) (2015): 164.

Likewise, the focus of the party-state does not always translate into productive economic outcomes. For example, the Benxi Iron and Steel Group (Bengang) in the rustbelt city of Benxi in China's northeast region, struggled to maintain profitability and competitiveness against similar SOEs on the coast that maintained easier access to coastal trading routes and ports.[134] In light of this challenge, Bengang began investing in real estate as a means of increasing bottom line profitability using government-issued credit.[135] While this practice increased the profitability of the firm on paper, it squandered private investment and failed to actually increase the profitability and productivity of the actual factory itself.[136] Thus, the interests of the state on both a local and national level led to both the manipulation of profitability outcomes for firms, and led to the inefficient and corrupt allocation of government resources.

Additionally, while state firms owned by local governments had access to roughly the same amount of credit as private industries in 2004, by 2011 locally owned state firms had increased access to credit to the point where the difference between the access to credit for central versus local state firms was statistically insignificant at -0.05.[137] Access to credit is highly political in nature, and is often influenced through channels such as the government ownership and operation of the largest Chinese banks, such as the PBOC, and the construction and implementation of credit policies, by the bureaucracies, for the banks.[138] During this period, state-owned firms had access to larger lines of credit compared to private industries, favoring the

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[134] David Stanway. "How One Chinese Region Shows Risks of Relying on Heavy Borrowing." *Reuters*, 22 Feb. 2017.

[135] Ibid.

[136] Ibid.

[137] Risto Herrala and Yandong Jia. "Toward State Capitalism in China?" *Asian Economic Papers* 14(2) (2015): 172.

[138] Ibid.

growth of the private sector while allowing state-owned firms to utilize government connections and status to gain access to increased funding.[139]

For instance, under Hu Jintao, through political pathways and biased lending policies for access to credit, local governments were both allotted a higher degree of control over development. Consequently, local officials were able to cultivate favorable preferential treatment towards local and centrally owned public enterprises. In fact, if capital were to be invested by the government into non-zombie firms during that time period, the growth rate of industrial output would be higher by 2.12%, with the total factor productivity growth higher by 1.06% as well.[140] This means that while the actions of the networks of favoritism within the party-state on behalf of its own economic interests fueled the creation of biased lending and credit accessibility policies cannot be said to have directly contributed to the slowing of of the Chinese GDP growth, they can be said to have prevented the economy from reaching its full growth potential. However, because attempts at reforms of the SOEs have cyclically failed and have been demonstrated to have negatively impacted growth, it can be said that the approach of the party-state towards the role of public enterprises in the Chinese economy is not aiding in growth. Therefore, the problem is not government investment and intervention, but the ineffective implementation and corrupt favoritism by the party-state that channels resources into inefficient zombie firms and subsequently stifles growth and productivity.

The reform agenda recently outlined by Xi Jinping aims at transforming SOEs into more productive and profitable entities. However, this drive towards profitability is not a push towards

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[139] Shiyong Zhao. "Government Policies and Private Enterprise Development in China: 2003-2006." *China & World Economy*, 17(4) (2009): 36–52.

[140] Yuyan Tan et al. "Zombie Firms and the Crowding-Out of Private Investment in China." *Asian Economic Papers*, 15(3) (2016): 32–55.

the operation of SOEs as determined by market forces. Instead, the plans, as outlined at the 2013 Third Plenary Session of the 18th CPC Central Committee in the decision on "Major Issues Concerning Comprehensively Deepening Reforms" focuses on the restructuring of SOEs to promote the overall appearance of profitability for the industry as a whole.[141] In a similar manner to many of the policy proposals of the party-state, the "Major Issues Concerning Comprehensively Deepening Reforms" focuses on the promotion of targeted achievements, but not the tangible methods for implementation of these goals. The reforms are orchestrated through the Comprehensive Reform Leadership Small Group (LSG), which is chaired by Xi and maintains oversight on the execution of the reforms through the corresponding bureaucratic agencies on both a local and national level.[142] For SOE reform, the corresponding 336 initiatives were distributed to the appropriate agencies: the State Asset Supervision and Administration Commission (SASAC), the Ministry of Finance, the National Development and Reform Commission (NDRC), and the Ministry of Labor.[143]

The plan is focused on three central pillars: no privatization, but greater investment of private capital; restructuring through holding companies; and the facilitation of mega-mergers as opposed to the deconstruction of monopolies.[144] The first aspect, privatization, allows for private investors to invest in public enterprises, but prohibits them from gaining a majority stake in any

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[141] Barry Naughton. "Reform Agenda in Turmoil: Can Policy-Makers Regain the Initiative?" *China Leadership Monitor* 48 (2016): 4.

[142] Barry Naughton. "Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage." *China Leadership Monitor* 50 (2016): 6.

[143] Ibid.

[144] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. "Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises" *MERICS: Mercator Institute for China Studies* March 2017: 1.

company.[145] Preliminary trials, such as the 2014 "mixed ownership restructuring" of the state oil company SINOPEC are indicative of how this reform is likely to be implemented. For example, while SINOPEC sold approximately 30% of its distribution to domestic and foreign investors for over 100 billion CNY (USD $13.89 billion), only 10% went to private investors, while the remaining 20% went to other SOEs or state-controlled financial institutions.[146] While SINOPEC was not an official pilot project, the move was approved by the NDRC, thus signaling approval from Xi for the 'privatization' of the SOE, signaling a high likelihood of the utilization of this method for additional SOE reform efforts.[147]

The second pillar, restructuring through holding companies, aims to create holdings through the merger of existing public enterprises. The China National Cereals, Oils, and Foodstuffs Corporation (COFCO) serves as a current pilot project, by the creation of holding companies through the acquisition of subsidiaries under the control of SASAC.[148] To date, COFCO has merged with China Grain & Logistics Corporation, and the Huafu Group (sugar, meat, and wine), and acquired a majority share in the Dutch agricultural corporation Nidera and the agricultural business of the Hong Kong Noble-group.[149] However, as the large SOEs transition into holding companies with an international presence, the lack of market-regulations or principles for SOEs is more likely to have an impact a substantial international markets,

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[145] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. "Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises" *MERICS: Mercator Institute for China Studies* March 2017: 3.

[146] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. "Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises" *MERICS: Mercator Institute for China Studies* March 2017: 4.

[147] Ibid.

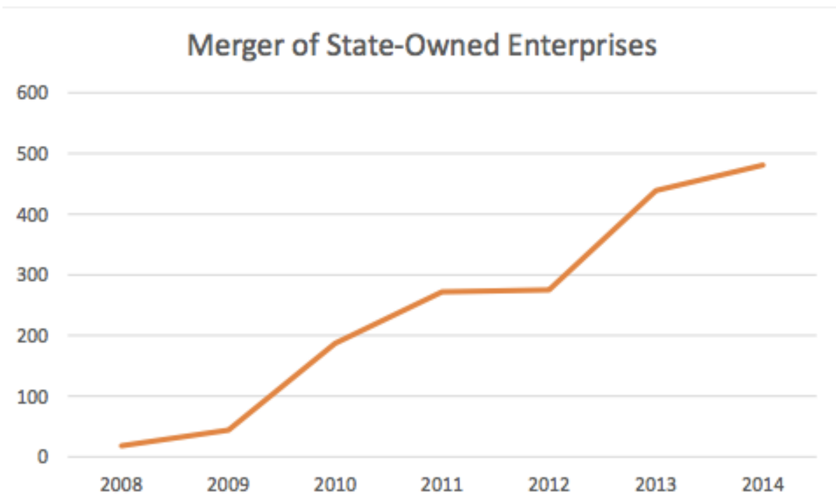
[148] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. "Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises" *MERICS: Mercator Institute for China Studies* March 2017: 7.

[149] Ibid.

particularly for the pricing and supply of commodities. Further, because this model would theoretically put the holding companies under the control of the Ministry of Finance (MOF) as opposed to the SASAC, it is likely to be the most challenging to implement.

The final pillar, mergers, is directed through the coordinated effort of 16 ministries, including the SASAC, MOF, NDRC, and PBOC. The number of mergers under Xi's direction has risen sharply, as indicated by Figure 3.6.[150] However, the formation of oligopolies and monopolies does not necessarily increase the productivity and profitability of public enterprises. Alternatively, the consolidation of firms and formation of oligopolies or monopolies could lead to the masking of zombie firms under the guise of firms that are overall more productive, and thus cover the loss of profit and inefficiencies of zombie firms. This could lead to the masking of the same problems facing the public firms as a whole under the positive performance of a select number of firms, and thus would not actually be representative of legitimate reforms.

Figure 3.6

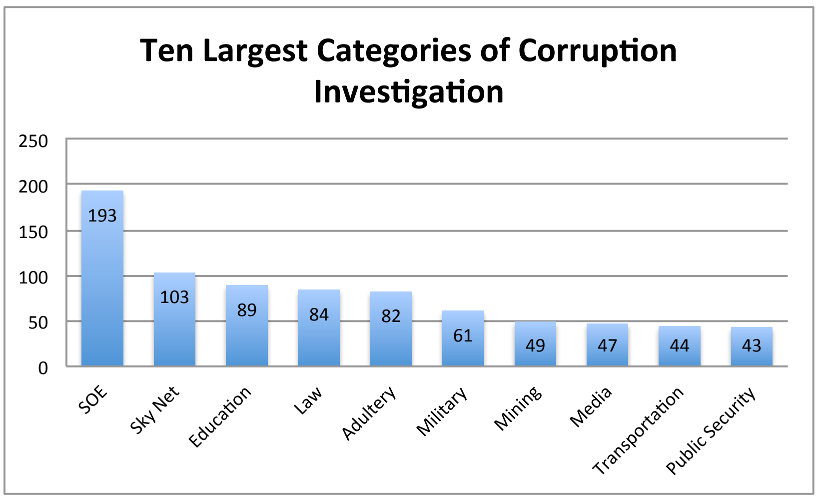


Finally, even though Xi Jinping's reform agenda for SOEs is more ambitious compared to efforts pursued by Hu Jintao, the fragmentation of reforms between agencies and across localities

[150] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. "Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises" *MERICS: Mercator Institute for China Studies* March 2017: 8.

has presented a significant risk to effective reforms. Furthermore, Xi Jinping has taken a more forceful level of supervision over SOE reform through other avenues. For example, of the 1,899 officials investigated for corruption charges under Xi Jinping, 193 were from SOEs.[151] In total, the officials are allegedly responsible for the embezzlement or misuse of ¥2,767,323,933 CNY (USD$ 402 million) of government funds.[152] As indicated by Figure 3.7, SOE officials are the largest target of Xi's anti-corruption campaign in terms of quantity of separate investigations, accounting for 10% of the total investigations.[153] Furthermore, with 73% of the investigated SOE Tigers Expelled/Arrested or Sentenced, it is clear that Xi is commanding a forceful watch over both the governance and practices of the SOEs, particularly as the Comprehensive Reform Leadership Small Group (LSG), and relevant related government apparatuses begin to attempt the implementation of Xi's SOE reform agenda.[154]

Figure 3.7



While local discretion and control was detrimental to the implementation of SOE reforms under Hu Jintao, the aggression of Xi's reform efforts as a whole and the fear instilled through

[151] David M. Barreda, et al. "Visualizing China's Anti-Corruption Campaign." *ChinaFile*, Center on U.S.-China Relations at Asia Society (21 Jan. 2016).

[152] Ibid.

[153] Ibid.

[154] Ibid.

his anti-corruption campaign could potentially lead to effective reforms of SOEs on a local level. For example, private equity firms have begun to invest in a number of local Shanghai SOEs, while Guangdong province has targeted private investment into 70% of its public enterprises by the end of 2017.[155] Furthermore, Shandong province has announced plans to transfer shares in all local SOEs to a social security fund, thus making the social security fund a capital manager that expects both high returns and greater efficiency. Therefore, while Xi is continuing with a degree of experimentation on a local level for SOE reforms, it is clear that new reforms, if successful, will radically transform both the composition and role of SOEs throughout China and their impact on global markets as well.

However, if the reforms are not successful, it is likely that the SOEs will continue to be subject to stagnation and corruption that will prevent the achievement of full economic growth within China. The inability of the reforms to be successful in this instance falls on the strength and capacity of institutions to implement these reforms. This ability is distributed throughout the party-state, meaning that mid and lower-level officials must also be motivated to change their patterns of behavior and implement the reforms that change the structure and relationship between the SOEs and the party-state as an institution. The high-level officials orchestrate the construction and approval of these policies and are motivated to implement these policies due to their appointments onto prestigious economic development and reform committees in order to demonstrate their own personal success. While this change theoretically possible, it is unlikely that these mid and lower-level officials will have a desire to change the system that they currently benefit from to one that is ultimately better for the health and stability of the Chinese

[155] Mirjam Meissner, Lea Shih, Luisa Kinzius, and Sandra Heep. "Like a phoenix from the ashes: Reforms are to bolster China's state-owned enterprises" *MERICS: Mercator Institute for China Studies* March 2017: 5.

economy in the long-term. Consequently, the likelihood of the successful implementation of SOE reforms rests on the ability of the mid and low-level officials to adopt a motivation for the implementation of the reforms that outweighs the benefits of continuing with the current system. While the following chapters will develop a more sustained explanation of the potential for the change in motivation, overall it is unlikely that this change will occur.

In conclusion, this chapter has demonstrated that the hypothesis that the Chinese party-state is favoring public over private enterprises, thereby impeding the development of an efficient, market-based economy and preventing potential growth is true under Hu Jintao. However, while this favoritism has been showed to have prevented China from achieving its full potential growth, it is not clear to what extent it has contributed to the slowing of the Chinese economy overall. Since the economy had, but did not achieve, the potential to grow by an additional 2% due to favoritism in credit allocation by state-actors towards state firms, is likely that this favoritism also contributed to the slowing in actual GDP growth as a whole. This is also demonstrated through the detrimental impacts on economic growth on the continued investment into ineffective and expensive infrastructure projects. Consequently, the actions of the party-state in favoring public enterprises have contributed to the economic slowdown. However, given the relative size of the private sector today in China, it is unlikely that the biased approach of the party-state towards SOEs alone provides the sole comprehensive explanation as to why the Chinese economy has slowed. Furthermore, the increase in profitability of SOEs as a whole by 6.7% during 2016 suggests that the reforms and aggressive approach of Xi are having positive impacts on the profitability of SOEs throughout China.

As the following chapter will illustrate, intervening factors such as large demographic changes and the inability of the party-state to transition the Chinese economy away from an input-led model of growth are having a far greater impact on the composition of the Chinese economy than the involvement of the state and the role of SOEs in the economy. However, as indicated by Xi’s aggressive stance towards the SOEs, the impact of these firms on draining productive uses of credit cannot be completely disregarded. Therefore, while the preferential politics towards state firms pursued under Hu Jintao contributed towards the slowing of the Chinese economy, the slowing of the economy is faulted towards the inefficient and ineffective involvement of the state, and not the fundamental involvement of the state in a transition economy.

Chapter IV

The party-state is unable to transition the Chinese economy out of a input-driven growth model, causing a slowdown in economic growth.

Chapter IV

The previous two chapters analyzed the impact of corruption and favoritism of the party-state towards public firms on the slowing of the Chinese economy. While these chapters demonstrated that both of these factors detrimentally impacted economic growth, neither the combination nor singularity of these two hypotheses provided a comprehensive answer as to why the GDP growth of the Chinese economy has slowed. To help develop a more comprehensive answer as to why the Chinese economy has slowed, this chapter will present a broader examination of the causative factors contributing to the slowing of the Chinese economy. These factors will be analyzed under the hypothesis that the party-state is unable to transition out of an input-driven growth model, which has led to a slowing of economic growth. This hypothesis rests on the view that state actors and institutions are unable to transition out of a model of factory-based, investment-driven growth. This analysis will proceed by first examining the changes in the labor force. This will be followed by an examination of the role of capital, growth of consumption, and relevant political challenges. Each will be evaluated for both its role in either causing or aiding in the transitioning of the Chinese economy as well as its role in the slowing of China's GDP growth using both quantitative and qualitative evidence.

The first component, labor, involves the changes that the Chinese labor force has undergone and the impact of these changes on the Chinese model of factory-based, investment led growth. Relevant factors include changes in the size of the population and labor force, stratification of the population, increase in income levels, comparative changes in labor costs, and increase in education levels. Each of these individual factors are considered within the context of how the change of the particular indicator has affected the labor force, and thus how the labor force has impacted the factory-based component of the Chinese-style of economic growth.

First, both the size and structure of the Chinese population have undergone dramatic changes over the past three decades. Under Mao, population growth was highly uneven, with high fertility rates continually encouraged.[156] However, this period was characterized by dramatic spikes and declines in both the birth and death rates— particularly during the Great Leap Forward and Cultural Revolution in which 30 million people died, leading to large fluctuations in the size of the labor force.[157] However, with the assumption of power by Deng Xiaoping and the release of the *Open Letter to All the Party Members and Youth League Members on Population Control* by the Central Committee of the CCP in 1980, the Chinese party-state has enforced stringent family planning policies in what has become to be known as the One Child Policy.[158] While the One Child Policy was officially terminated in 2016, over the course of its existence the policy dramatically steadied and slowed the growth rates and the demographic structure of the Chinese population, as indicated by Figure 4.1.[159] While the policy was updated throughout its existence in order to provide special relaxed provisions for, among other things, families living in rural areas, who had a girl as their first child, and for ethnic minorities, these changes did not significantly impact the trend of declining

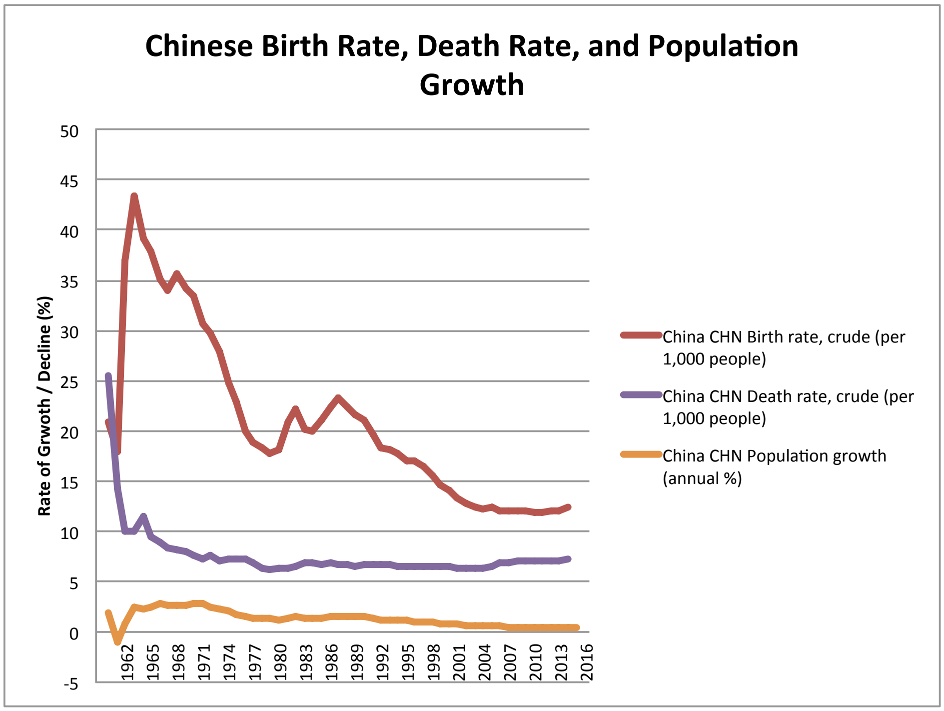
156 Ezra F. Vogel. Deng Xiaoping and the Transformation of China. (Belknap Press of Harvard University Press, Cambridge, 2011): 434 - 435.

157 Sam Crane. "Chinese Nationalism and the Great Leap Forward." *The Useless Tree* (4 Dec. 2008).

158 Yang Du, and Cuifen Yang. "Demographic Transition and Labour Market Changes: Implications for Economic Development in China." *Journal of Economic Surveys* 28(4) (2014): 617-618.

159 Ibid.
The World Bank. "Population Growth (Annual (%)." *The World Bank* (2016).

Figure 4.1



birth and population growth rates.[160] In a similar manner, due to the advancements in medical care and quality of life during this time period, the Chinese death rate stabilized, indicating that access to public health services had stabilized and was controlled throughout the country.[161]

However, while the One Child Policy led to the reduction of both the birth and population growth rates, it also significantly transformed the age structure and dependency ratios for the Chinese population. As Figure 4.2 shows, the population structure of China changed dramatically during a relatively short period of time due to the implementation of the One Child Policy.[162] These policies were effective in constraining both the size and growth rate of the Chinese

[160] Yang Du, and Cuifen Yang. "Demographic Transition and Labour Market Changes: Implications for Economic Development in China." *Journal of Economic Surveys* 28(4) (2014): 618.

[161] Yang Du, and Cuifen Yang. "Demographic Transition and Labour Market Changes: Implications for Economic Development in China." *Journal of Economic Surveys* 28(4) (2014): 619.

[162] Yang Du, and Cuifen Yang. "Demographic Transition and Labour Market Changes: Implications for Economic Development in China." *Journal of Economic Surveys* 28(4) (2014): 622 - 623.

Figure 4.2

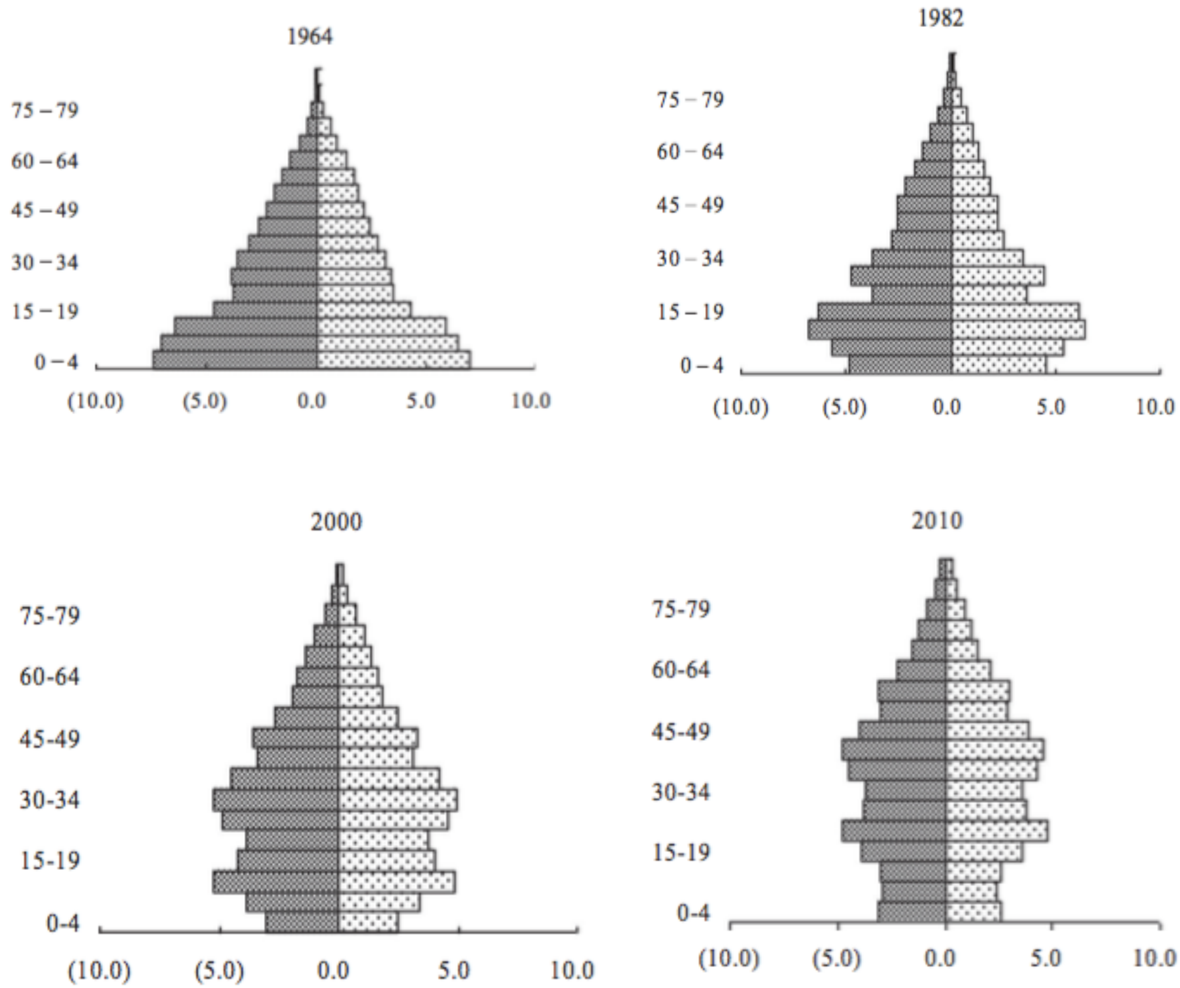
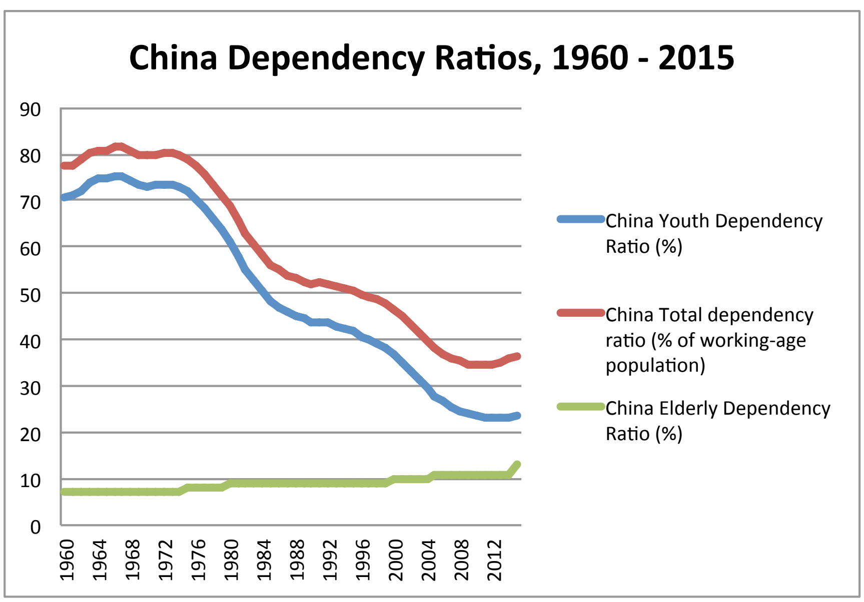


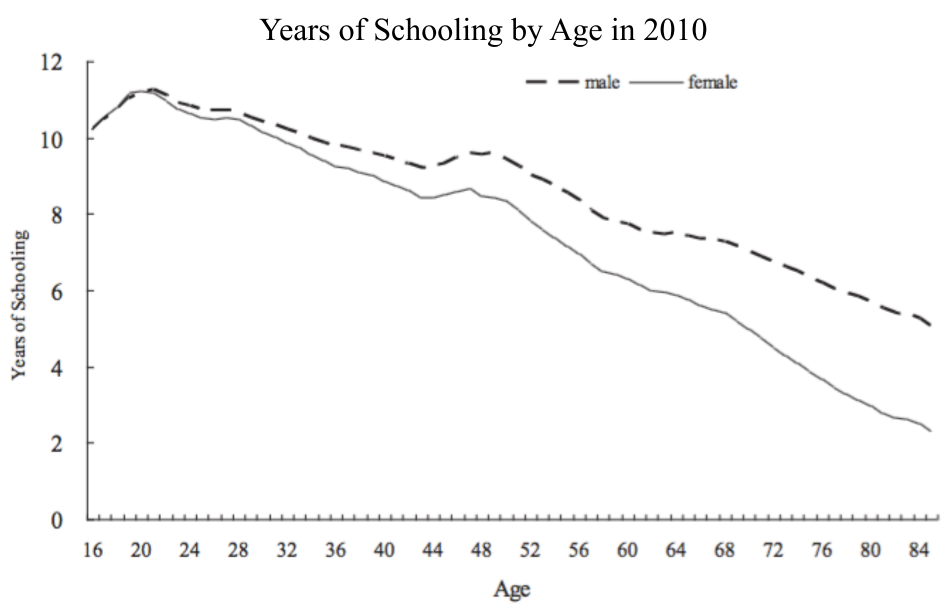
Figure 4.3



population, and contributed towards an increase in life expectancy and quality of life.[163] They also led to a decline in the size of the workforce and a subsequent increase in the dependency ratio today, as indicated by Figure 4.3.[164] As a consequence of the decrease in the birth rate, not only is the labor force today smaller in comparison to previous decades, but the working population is now responsible for an increasing proportion of the population, as the elderly population continues to grow despite a decrease in the fertility rate. Further, the decrease in the fertility rate more recently means that the size of the labor force will continue to decrease, indicating that the Chinese labor force will continue to shrink in future generations.

This change in the population structures and birth rates have coincided with an increase in both the quantity and quality of educational opportunities within China. As indicated by Figure 4.4, in 2010 those aged 30 or below had completed 10 years or more of school on average.[165] Over the past several decades, the

Figure 4.4



[163] Ibid.

[164] The World Bank. "Age Dependency Ratio (% of Working Age Population)." *The World Bank (*2016).

[165] Yang Du, and Cuifen Yang. "Demographic Transition and Labour Market Changes: Implications for Economic Development in China." *Journal of Economic Surveys* 28(4) (2014): 630.

party-state has been able to significantly expand access to educational opportunities. Compared to more elderly sectors of the workforce or population, members of younger generations receive not only a longer, but also a higher quality education.[166] Consequently, these policies have aided in the creation of a workforce that is better educated and more capable compared to previous generations. Furthermore, with the cohort of workers aged 50-64 expected to leave the workforce by 2020, China is rapidly approaching the formation of a workforce that is composed of fewer, but more educated workers, thus changing the desires and composition of the workforce compared to previous decades.[167] This is better for long-term, advanced economic growth, as it signals the ability to grow and support a service sector and advanced technological innovation. However, the decrease in size and increase in education of younger generations does not align with the needs of a factory-based, labor-heavy economy that relies upon cheap and readily available labor.

Further, these changes have coincided with a dramatic change in the wage levels and structure for the Chinese population as a whole. Figure 4.5 provides an a more focused account of the changes of the wages of Chinese workers when excluding those confined to rural professions such as agricultural jobs, and thus provides a description the economic growth incurred by China over the past 30 years.[168] While this increase in the annual wage for urban workers in China is positive in that economic growth has had a positive impact on workers as well, it also signifies that labor has gotten more expensive in China. This increase in labor costs makes sense when viewed in light of the changes in the size of the labor force, as the shrinking

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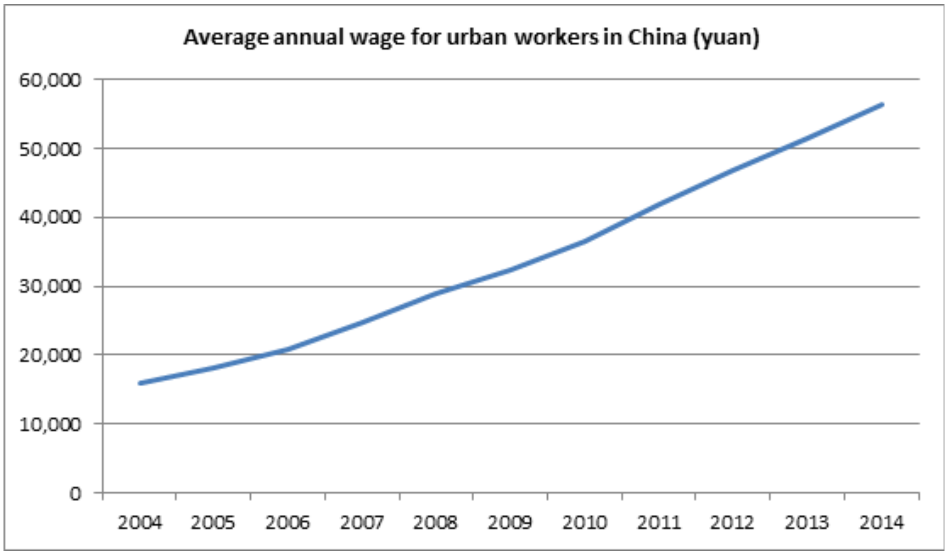
[166] Ibid.

[167] Ibid.

[168] China Labour Bulletin. “Wages and Employment.” *China Labour Bulletin*, (4 Aug. 2015).

Figure 4.5



size of the labor force has reduced the supply of cheap labor, making the demand for these positions higher and driving up wages, but also the cost of labor for factory owners.

However, this wage growth has not been homogenous throughout the nation, with a majority of the economic growth concentrated in coastal regions with greater industry, FDI, and job opportunities. Following the 2008 global financial recession and the desire of the party-state to cultivate the growth of central and western provinces in recent years, many of the low-wage factory jobs have shifted into more centralized geographic regions of the country.[169] Consequently, despite the overall increase in the annual wages for urban factory workers, this growth has not been uniform, resulting in a wage disparity between coastal and central regions.[170] This disparity also means that the overall labor costs are still moderate, especially when viewed in a comparative perspective, as indicated by Figure 4.6.[171] Therefore, while it is

[169] Jeremy L. Wallace. "Return to Sender: Hukou, Stimulus, & the Great Recession ." *Cities and Stability: Urbanization, Redistribution, & Regime Survival in China*, (Oxford University Press, New York) (2014): 159–185.

[170] Ibid.

[171] Jost Wübbeke et al. "Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries." *Mercator Instituite for China Studies*, 2 (Dec. 2016): 16.

Figure 4.6

true that there is still cheap labor in China, the supply of this labor is diminishing, and the cost of this labor varies dependent on geographic location. Further, while overall labor costs in China are still cheaper compared to more developed countries, the continued consistent increase in wages suggests that labor costs are not likely to decrease in the future. Thus, the party-state's continued focus on the growth of the input-driven economic model through a reliance upon cheap and plentiful labor supplies is not reflective of the reality of the composition of the labor force within China. This signals that the party-state's approach towards economic growth is outdated and misaligned with the reality of the composition of the Chinese population.

The changes of both the size, age, and wealth of the Chinese workforce culminate in the transition of China beyond the Lewis Turing Point (LTP). Coined by the economist W. Arthur Lewis, the term refers to the point in time in which a country's supply of surplus rural labor is diminished to the point where the growth rate of labor demand is greater than the growth rate of labor supply.[172] At this point, a country enters into a labor shortage, causing an increase in wages

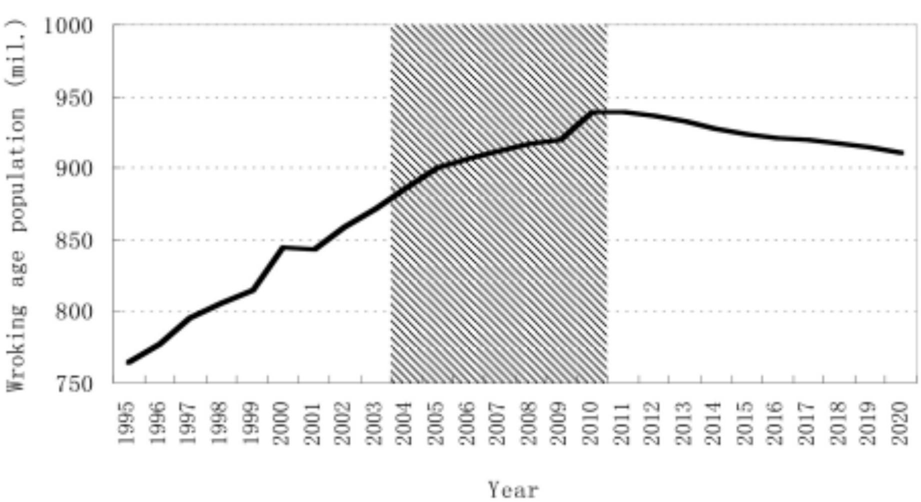
[172] Gustav Ranis,. "Arthur Lewis' Contribution to Development Thinking and Policy." *Economic Growth Center-Yale University* 891 (Aug. 2004): 7.

across sectors.[173] Furthermore, the supply-side shortage often leads to an economic slowdown, causing a decrease in GDP growth from the point in which the LTP is reached.[174]

Due to the geographical heterogeneity and disparities between various regions in China, the LTP is more commonly referenced as the Lewis Turning Period.[175] These economists target the period between 2004 and 2010 as the time in which fragments of China individually experienced their own LTPs, depending on the unique wage structures, population demographics, and local industrial opportunities.[176] In relation to the development trajectory of the Chinese economy, based upon the existing population structure, working age population, wage structures and fertility rates, economists postulate that China as a whole reached the LTP by 2010.[177] For example, as evidenced by Figure 4.7, by 2010 the working age population in China peaked and began to decline. This decline thus places a definitive time

Figure 4.7

China Lewis Turning Period



[173] Ibid.

[174] Ibid.

[175] Garnaut, Ross, et al. "The End of China's Demographic Dividend: The Perspective of Potential GDP Growth." *China: A New Model for Growth and Development*, (ANU E Press, Canberra) (2013): 55.

[176] Ibid.

[177] Ibid.

period for the point in which the effects of the One Child Policy and increase in wages shifted from a positive to a negative impact on the input-driven economy.[178] From this point onwards, the labor shortage within the Chinese economy shows that economic growth could not be sustained through access to cheap labor in the same way that the party-state had been able to previously direct under cheaper labor.

In line with the predictions first voiced by Lewis, China's GDP reached a peak for the past decade in 2007 with a high of 14.231% annual GDP growth.[179] Since this peak, China's annual GDP growth has decreased and failed to reach these previous levels of growth.[180] The decrease in the rate of annual GDP compared to earlier years signals not only the effect of the LTP on GDP growth, but of the need for a new growth strategy for China, as the

Figure 4.8

[178] Garnaut, Ross, et al. "The End of China's Demographic Dividend: The Perspective of Potential GDP Growth." *China: A New Model for Growth and Development*, (ANU E Press, Canberra) (2013): 56.

[179] The World Bank. "GDP Growth (Annual %)", *The World Bank (*2016).

[180] Ibid.

slowing of the Chinese economy is consequently largely due to the effects of the demographic transitions on changing the composition of the economy.

The completion of the Lewis Turning Period for the Chinese economy leads to the development of what economists have defined as the Middle Income Trap. Defined broadly as "the economic slowdown of GDP growth experienced after a country has grown rapidly for a sustained period of time," the Middle Income Trap is commonly utilized as the explanation for the slowdown in growth for developing countries.[181] The term utilizes the word 'trap' to signify the inability of countries to transition from input and industry-led economies into higher value-added production or service based economies, For instance, of the 101 economies classified as middle-income in 1960, only 13 had become high income by 2008 (Equatorial Guinea; Greece; Hong Kong, China; Ireland; Israel; Japan; Mauritius; Portugal; Puerto Rico; South Korea; Singapore; Spain; and Taiwan).[182] Overall, evidence suggests that countries are most likely to hit the Middle Income Trap when domestic per-capita income reaches US$ 17,000 (2005 prices). After this point, GDP growth slows by at least two percentage points.[183]

When applied to the Chinese growth trends, The Middle Income Trap model predicts China surpassing the US$ 17,000 (2005) per-capita income mark by 2015.[184] As evidenced by Figure 4.9, despite the regional disparities in income, China as a whole is rapidly approaching the Middle Income Trap, meaning that certain geographical areas have already surpassed the

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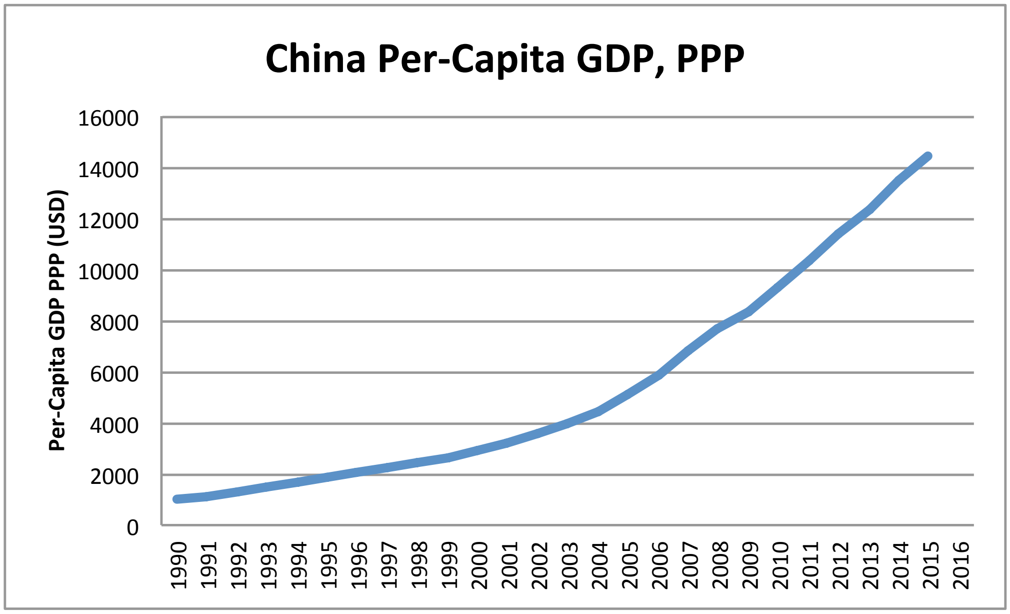
[181] Pierre-Richard Agénor and Otaviano Canuto. "Middle-Income Growth Traps." *Research in Economics* 69(4) (2015): 641.

[182] Ibid.

[183] Barry Eichengreen et al. "When Fast-Growing Economies Slow Down: International Evidence and Implications for China." *Asian Economic Papers* 11(1) (2012): 42.

[184] Ibid.

Figure 4.9



turing point.[185] When the Middle Income Trap is viewed in conjunction with the Lewis Turning Point, it is apparent that China's slowdown in GDP growth is driven by the cumulative effect of demographic changes that have altered both the composition and desires of the labor market. These changes result in a labor sector that is misaligned with the needs of an economic model that operates on the premise that labor must be cheap and readily available.

Consequently, the motivations for the party-state's increase in the utilization of capital as a driver of economic growth is explained by the misalignment between the needs of the input model and the shift in the composition of the labor market during the time period of 2002-2015. As the following analysis will illustrate, the party-state, struck by inertia with regard to economic development, has lacked the institutional capacity to transition into a innovative, technologically advanced and service based economy. Because the party-state was not able to fuel economic growth through an increase in the supply of labor, the only other option under an factory-based, investment-led model of economic growth was to increase the amount of capital. Consequently,

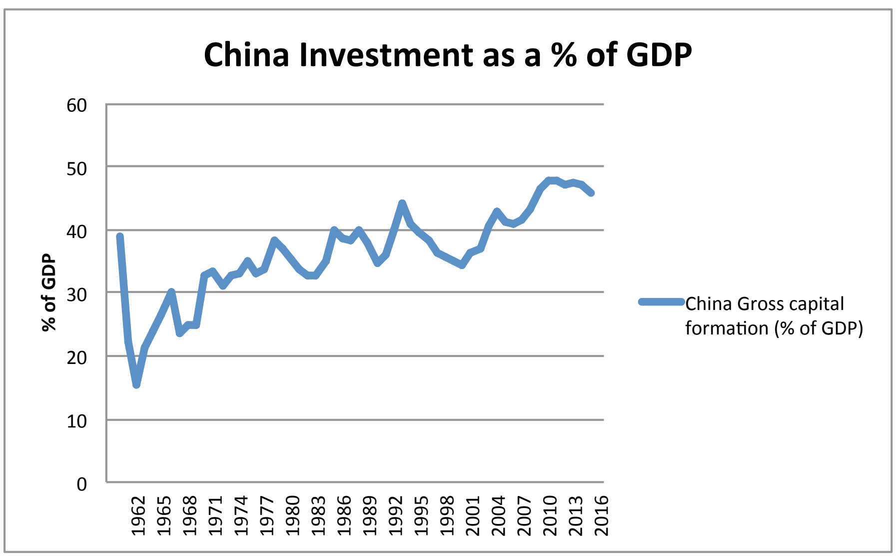
[185] The World Bank. "GDP per Capita, PPP (Current International $)", *The World Bank* (2016).

the institutions of the party-state increased the influx of capital into the economy in an attempt to maintain high levels of growth in the absence of cheap and plentiful labor.

On the most basic level, investment in the form of monetary capital is necessary and important for economic growth because it provides the monetary means to achieve economic growth. However, the input of capital does not guarantee that the investment will be productive, meaning that it will generate economic growth. Furthermore, the input of capital also does not guarantee the achievement of a particular level of economic growth. Therefore, although monetary investment is needed for economic growth, a variety of factors affect the impact and outcomes of this capital influx.

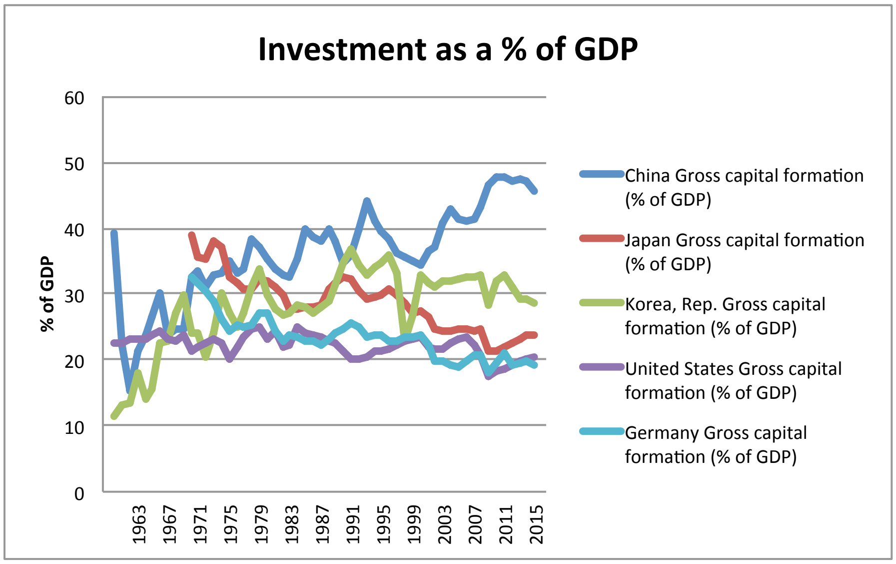
In an attempt to counteract the effects of the changes in the labor market, in recent years the party-state has increasingly relied upon capital as a driver of economic growth. For example, as indicated by Figure 4.10, investment as a percentage of GDP rose dramatically as the labor sector of the Chinese economy began to reach both the LTP and Middle Income Trap.[186] This indicates that in response to changes in the labor sector, the party-state injected more capital into the economy in

Figure 4.10



[186] The World Bank. "Gross Capital Formation (% of GDP)", *The World Bank (*2016).

Figure 4.11



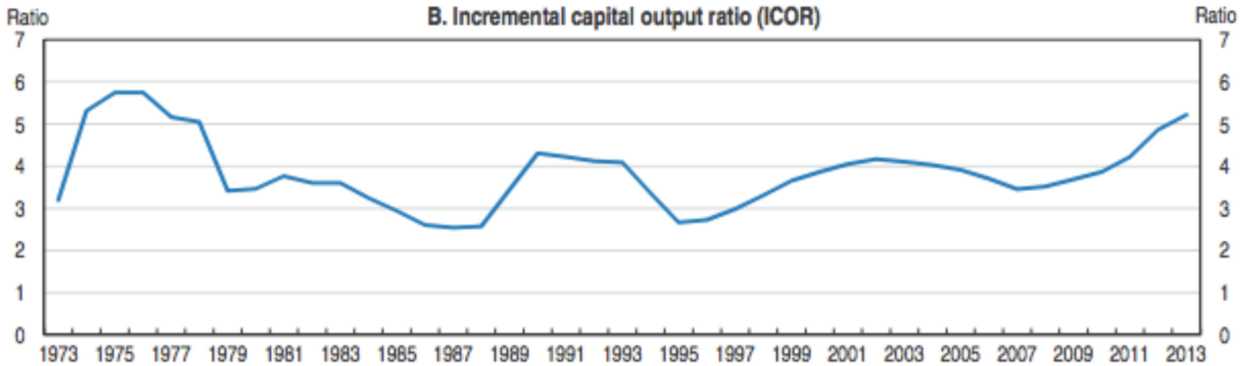
order to continue to fuel growth. Furthermore, when compared with investment as a percentage of GDP for more economically advanced countries, China's investment as a percentage of GDP is substantially higher, and has accentuated its growth trajectory since the mid-2000s.[187] Therefore, in a response to the changes in the labor force, the party-state dramatically increased the influx of monetary capital into the economy in an attempt to continue to produce high-levels of economic growth.

However, because this investment was injected into an economy that was reliant upon a labor force that had shrunken and shifted its interests within the market, the investment was not utilized in a productive manner. As indicated by Figure 4.12, China's capital to output ratio increased during this period, indicating a decrease in the productivity of Chinese capital investment.[188] This indicates that even though the party-state attempted to increase economic growth during this period, this growth was not actually productive, as significantly more capital investment was needed in order to have the same economic impact that small amounts of capital

[187] Ibid.

[188] Margit Molnar and Ben Westmore. "OECD Economic Surveys: China." *OECD* (2015): 26.

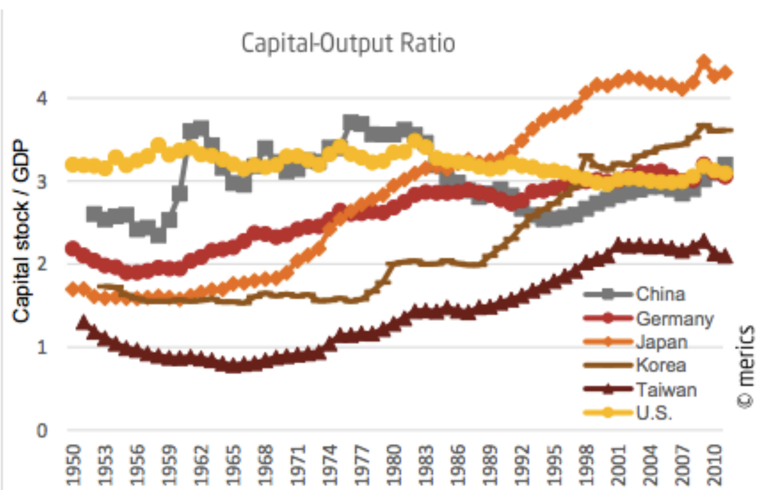
Figure 4.12



would have had under an economy that had a labor market that was more closely aligned with the factory-based, investment heavy model promoted by the party-state.

As indicated by Figure 4.13, while China's capital to output ratio is not exceedingly high compared to developed nations, these countries have largely transitioned away from a purely input led model of economic growth, and thus capital and labor are not the sole driving forces of economic growth within these countries, making a higher capital to output ratio less severe of a problem.[189] The exception to this categorization is Japan, which has the highest capital to output ratio. Unlike countries such as Germany and the United States, Japan has been unable to transition its

Figure 4.13



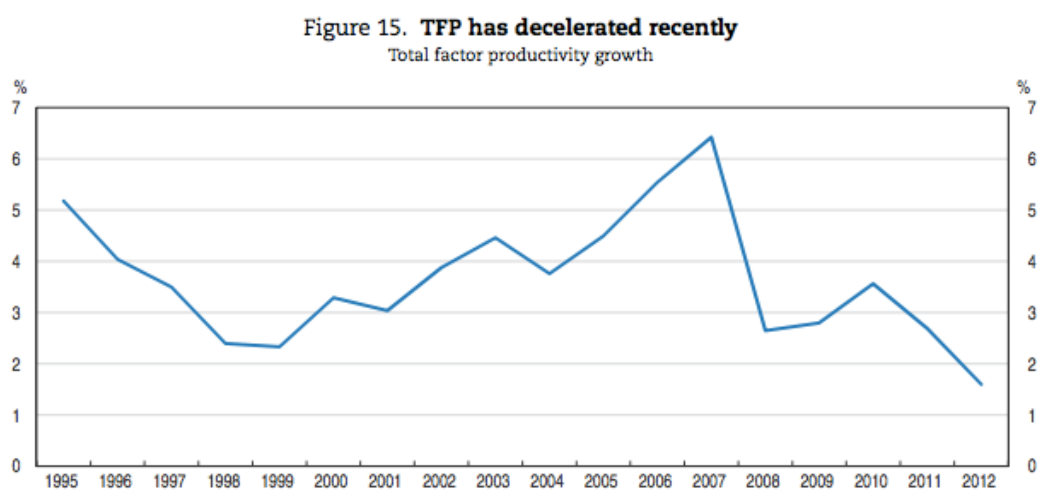
Source: PWT 8.1. Variable: capital stock at constant 2005 national prices (in 2005 USD) divided by real GDP at constant 2005 national prices (in 2005 USD). Values are for 1950-2011 as available.

[189] Carsten A. Holz. "Is Excessive Domestic Investment Hurting China?" *China Monitor, Mercator Institute for China Studies* 29(18) (Nov. 2015): 6.

economy away from an investment-led model of growth. Consequently, Japan has suffered from negative growth rates for the past two decades along with an continued increase in their capital to output ratio. Therefore, Japan serves as a warning for China. If the party-state is unable to transition out of an investment-led model into a more diversified model of economic growth, they are likely to face a low or negative GDP growth rate in the future.

Additionally, if China were to be investing the capital into advancements in technology and innovation, the Total Factor Productivity for China would rise as a percentage share of growth. Defined as the "portion of output not explained by the amount of inputs used in production," TFP indicates the effects of the growth of total output in relation to the growth of labor and capital, and thus is often utilized as a measure of innovation and technological advancement for input-led growth models.[190] However, as indicated by Figure 4.14, the rate of

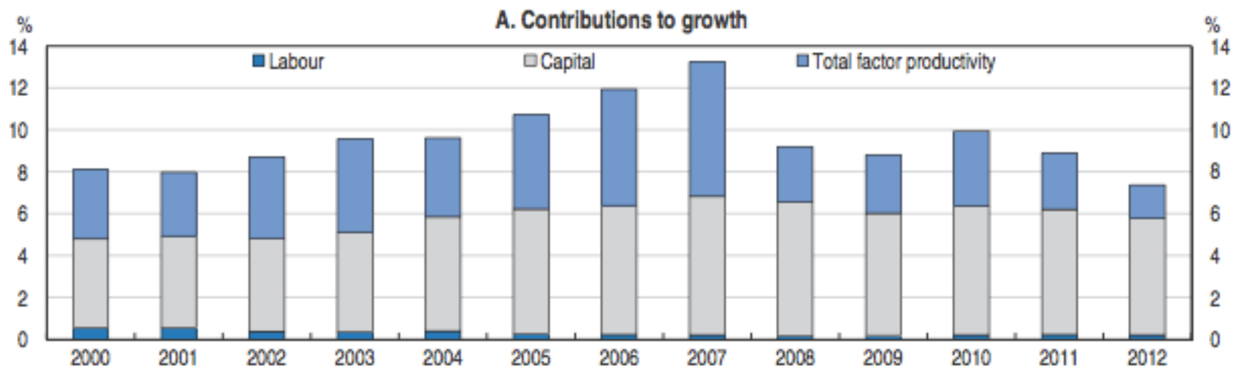
Figure 4.14



[190] Diego Comin. "Total Factor Productivity." (Aug. 2006): 1.

TFP growth for China has declined.[191] Therefore, not only has China invested larger amounts of capital recently that have been less productive compared to historical industrial investments of the same size, this capital is not being used to upgrade the technology of a factory in order to increase productivity. In a similar manner, as indicted by Figure 4.15, the proportion of TFP as a percentage of GDP growth has declined, and is complimented by an increase in capital.[192] Within

Figure 4.15



this, labor has continued to decrease, becoming an almost inconsequential component of GDP growth for China. This indicates that despite the continued influx of large amounts of monetary capital into the economy, this investment is not generating as much output for the same amounts of capital input as compared to previous years. Additionally, this capital is not being utilized to upgrade the technological capabilities of firms, singling that the firms are likely to continue to see an increase in the capital to output ratio, as both the size of the labor force continues to decline and wages continue to increase.

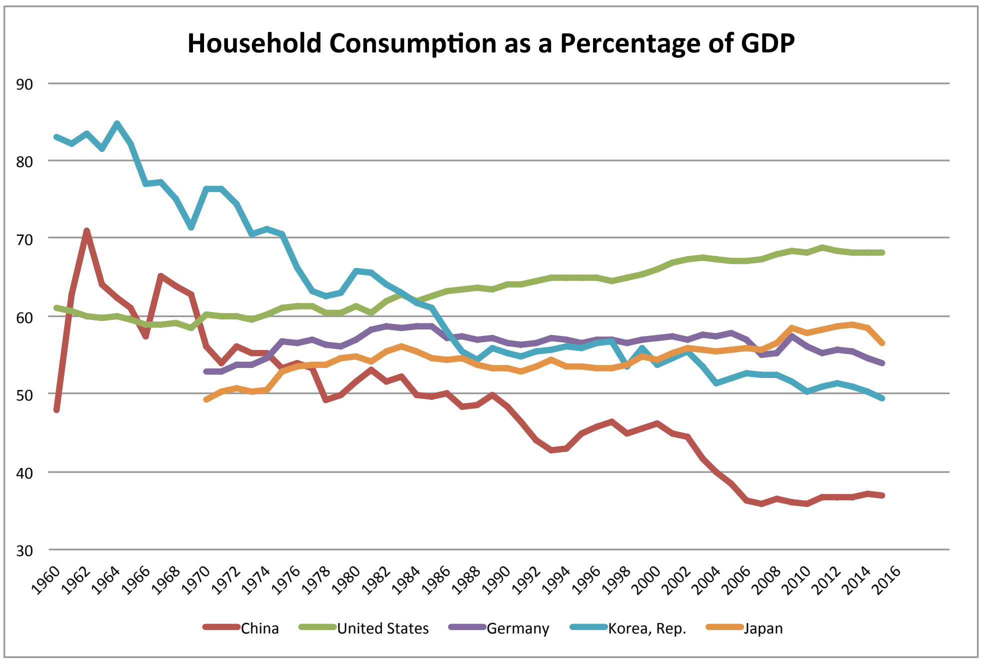
Consequently, when Figure 4.15 is viewed within the context of the party-state's approach towards economic growth for a transition economy, it is clear that the current growth

[191] Margit Molnar and Ben Westmore. "OECD Economic Surveys: China." *OECD* (2015): 26.

[192] Ibid.

model is both unsustainable and ineffective. Despite the fact that the Chinese population has transitioned beyond the characteristics of a manufacturing-based economy, the party-state has yet to transition its policy framework for economic growth models, leaving the economy stuck in an outdated and unproductive model. The growth of consumption within China has lagged, as evidenced by Figure 4.16.[193] Therefore, despite the increase in the wages in China as previously demonstrated, the Chinese economy has not transitioned away from its purely input-led model into a more diversified model. The continued disparity between household consumption as a percentage of GDP for China compared to developed nations indicates that China's economy, has be able to grow, but not transition.

Figure 4.16



If the Chinese economy were operating under free-market principles, the role of the party-state in hampering this economic advancement and transition would not need to be considered, as the problem would likely not exist. However, given the direct role of the party-

[193] The World Bank. "Household Final Consumption Expenditure, Etc. (% of GDP)", *The World Bank* (2016).

state in directing economic growth both through direct and indirect measures, the impact of politics on the slowing of economic growth must be considered. This analysis will consider not only the specific political challenges facing the party-state, but the basis for these issues as well.

Under the tenements of a transition economy, the state should continue to have an active role in the transition of an economy from state-planning and aid the continuation of a transition towards the greater integration of market forces and towards the creation of a more advanced and diversified economy. However, the economic and demographic data presented earlier demonstrates that the while the party-state has played an active role, recently this involvement has hampered, not facilitated, this transition and economic growth. Official policy proposals continually outline reform measures, plans, and timelines for sectors of the economy such as SOEs. But these plans for the reform and restraint of existing practices meant to control access to capital in an effort to change patterns of growth are often met with failure.[194] For example, while the party-state has been addressing SOE reform since the 1990s in official party-documents and platforms, these reforms are often never accomplished, as evidenced by the continued rephrasing and rebranding of reforms to SOEs.[195] Under this model, mid and lower-level party-state officials have less motivation to transition out of the input-driven model than they do to continue the operationalization of the current model in which they reap personal benefits as a result of their position within the party-state. Therefore, capital continues to flow into SOEs and other unproductive investments through the channels of the party-state.

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[194] Barry Naughton. "Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage." *China Leadership Monitor* 51(1) (30 Aug. 2016): 1–10.

[195] Ibid.

This inability of the leaders of the party-state to change the directionality of capital investment from unproductive to more productive uses is indicative of the institutional restraints on change within the party-state. While the size of the party-state makes the accomplishment of any task challenging, if the party-state were not constrained by internal institutional barriers, reform and a subsequent transitioning of the Chinese economy would have made progress. This progress would have been accomplished through the ability of the party-state to work together as a cohesive unit, and not hampered by officials within the party-state acting based upon their own conflicting self-interests. For example, under the current input-based system, virtually every member of the party-state benefits from the allocation and investment of capital as a driver of growth. In fact, the only members of the party-state who would benefit in the immediate future from the transition away from an input-based model of growth would be the high-level officials who are responsible for the transition and growth of the economy. However, the transition to a market-oriented economy not only means the loss of benefits under the system, but the transition of many of the current ‘winners’ into ‘losers’ who do not benefit under a market-oriented system. For example, for the non-preforming SOEs who continue to receive generous state support, this transition would mean unemployment and a complete loss of the benefits that are often affiliated with the management of central SOEs. Although the transition to a market-based economy is more beneficial in the long-term for the Chinese economy as a whole, the vast majority individual actors within the system oftentimes do not perceive these abstract, long-term benefits as more salient than the threat of losing their jobs in the immediate future.

This resistance of individual actors culminates in the creation on institutional barriers to change, creating a path-dependence on the input-led model for the party-state. A narrow definition of path-dependence within political science suggests that "that once a country or region has started down a track, the costs of several are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice."[196] Therefore, the inability of the party-state to transition away from the model of input-level growth is explained within the context of this definition of path-dependency, in that the reversal of the initial input-based model of economic growth is hard, and the costs of implementation are very high on both a system-wide and individual level. These challenges and high costs associated with the transformation of the system are explained by the tendency of mid and lower level actors to desire to continue to follow the established system of input-led growth, as they benefit from the system. While high-level actors within the party-state wish to implement changes to the system of economic growth because their motivations of success in their job rests upon this attempted reform, this motivation only pertains to the highest levels of the party-state.

Further, because a change away from a model that is already path-dependent typically only occurs in the face of a large and consequential event, it is unlikely that the Chinese party-state itself will be able to transition away from the input-model of growth without the occurrence of such an event. Consequently, it is likely that the high-level leaders of the party-state will continue to attempt to implement reform measures, which will be met with institutional restraint from the lower levels of the party-state who are motivated by their benefits under the current system to hamper any attempts to change the current system. Therefore, unless there is a dramatic change to the stability of the economy or rule of the party-state, it is unlikely that mid

[196] Margaret Levi (1997, 28) as quoted in: Paul Pierson. "Increasing Returns, Path Dependence, and the Study of Politics." *American Political Science Review* 94(2) (2000): 252.

and lower level actors will undergo a change in motivation that shifts from the desire to keep the current system in place to one where reform is seen as the best option.

In summation, this path-dependence by mid and lower level members of the party-state on a model of input-led growth explains the inability of the party-state as a whole to transition its approach towards economic growth from an input-led model to a more advanced and diversified model of economic growth in light of the demographic changes undergone to the Chinese population. The combination of the demographic changes incurred to the Chinese population over the last three decades as a result of the One Child Policy has dramatically shifted the composition and focus of the labor force in recent years, making the labor force smaller, more educated, and more accustomed to a higher quality of life. However, the party-state has been unable to transition away from an input-model of growth in response to these changes, and has subsequently dramatically increased investment in an effort to continue to drive growth. But this capital influx has not been not utilized productively within the economy, leading to the slowing of GDP growth, as the capital continued to be invested into factories that operated under an outdated and misaligned model of growth. Further, the capital was not used to increase the productivity of the factories, as evidenced by the decline in TFP. As this explanation encompasses the most factors and characteristics of China, it serves as the most comprehensive explanation to why the Chinese economy has slowed. However, corruption and favoring of public over private enterprises are inherently related to the path-dependency and institutional rut faced by the party-state, and are consequently part of the answer as to why the economy as slowed. Based upon the interplay of these factors, the following chapter will offer some predictive thought as to the challenges faced by the party-state moving forward, but also the prospects for future growth.

Chapter V:

Conclusion: Is a Transition Possible?

Chapter V

The previous chapters have demonstrated that the inability of the party-state to transition away from an input-led model of growth in response to the changing demographics of the Chinese population provides the most comprehensive explanation as to why the Chinese economy has slowed. However, both the impact of corruption and favoritism of public over private enterprises are also contributing factors to the slowing of economic growth under this conclusion. In fact, taken together, factors from each hypothesis provide a comprehensive model for achieving an understanding of both the issues facing the Chinese economy and the impact of those issues on the slowing of China's economic growth. They show ultimately that China has been unable to transition into a more advanced and diversified economy due to institutional barriers created and perpetuated by the competing motivations of lower versus higher level officials within the party-state. While China's current model has facilitated rapid, factory-based and investment-led growth in the past, which matched the previous demographic composition of the Chinese population well, changes to the Chinese population and society have rendered the current model unsuitable for continued economic growth in the present and future. Consequently, the slowing of the Chinese economy is explained not only by the perpetuation of an institutional rut that prevents the transition out of the input-led model, but also by a corresponding detrimental impact of corruption and favoritism of public over private firms within a system that no longer meets the needs of the greater China economy and society.

This conclusion prompts two follow-on questions. First, what needs to occur for the Chinese economy to shift? Second, does the party-state leadership possess the institutional capacity needed to orchestrate this shift? Combing the evidence and conclusions from the previous three chapters, this chapter will examine both steps the party-state needs to take to transition the Chinese economy, and, if successful, the implications and impact of this shift on the Chinese economy.

For the first hypothesis, corruption, it was postulated that rampant corruption in China had left the bureaucracy ineffective and stifled economic growth throughout the country. When the Corruptions Perceptions Index (CPI) for China was compared with GDP growth, there was an inverse relationship between the level of corruption and GDP growth during Hu Jintao's 2009-2011 tenure. However, there was no sustained correlation between the level of corruption and GDP growth for the period of 2012-2015. While it can be said that there was a correlation between corruption and GDP growth for the period of 2009-2011, whether such a correlation between perceptions of corruption and GDP growth exists for 2012-2015 is unclear.

The combination of both this correlation and additional results from academic literature suggests that while corruption likely previously aided economic growth, it also is likely not true today as a result of larger changes in the institutional system that corruption operates within. Given the inability of the party-state to transition to a more advanced and diversified model of economic growth, corruption as it operated with the institutional system of the Chinese economy transformed from a positive to a negative influence. This transformation is likely credited towards the changing nature and productivity of the system as a whole, and not towards the increase in proliferation of corruption throughout the party-state. Therefore, corruption is detrimental given the larger problems of the system that it is operationalized within.

While it is likely that corruption no longer has the same positive impact on economic growth in China that it had during previous years, the impact of corruption on economic growth generally is likely not large. However, it is likely that under an input-based model of growth, corruption, as facilitated through *guanxi* networks, was helpful in the allocation of credit towards factories. Because the labor force was previously aligned with the needs of a factory-based, investment-led economy, the utilization of corruption through *guanxi* networks in this instance facilitated growth. This was possible in part because corruption was operationalized within a state that was strong enough so that corruption did not hamper the overall efficiency of the state apparatus. However, given changes in the labor force over the past fifteen years, the allocation of capital through corruption has become quite inefficient. Therefore, it is likely that the increase in the perception of corruption and the perceived impact of corruption on economic growth is correlated with a shift in the labor market and the larger problems of the party-state's inability to shift away from a input-based growth model.

Consequently, the intensity of Xi Jinping's anticorruption campaign within the party-state can be perceived as a method of both ridding the party-state of highly corrupt officials, and also as a mechanism of power consolidation in an attempt to give the party-state the institutional capacity to shift away from an input-led model. In this manner, the objectives of the campaign are two-fold: to increase the power and cult of personality of Xi Jinping and to create a cleaner, more efficient bureaucracy. Because of the substantial risk of loss that likely would be incurred by many members of the party-state in a shift away from an input-based model of growth, economic reforms proposed by high-level officials that change the benefits flowing to individual members of the party-states have been met with institutional restraints from lower level members. Nonetheless, the increase in personal power and populist image of Xi, if his anti-corruption campaign is able to eradicate elements of the path-dependency on an input-based model, may make change within both the party-state and economy may be possible.

Relatedly, the second hypothesis, statism, considered whether the party-state favors public over private enterprises, thereby impending the development of an efficient, market-based economy and preventing the achievement of full potential economic growth. This analysis began with an examination of the historical trajectory and approach towards the transition of state-planning towards market-based principles of economic growth for the party-state. In applying this analysis to the current approach of the party-state, it could be seen that the party-state not only has failed in its attempted reforms of SOEs, but actually has favored SOEs over private enterprises in the allocation of capital on both a local and national level. While China was unable to reach its full potential GDP growth levels because of the resulting inefficient allocation of capital, there also could be found no direct evidence that this allocation impeded growth. Further, the value of contribution of industrial SOEs and SHEs is consistently shrinking as a percentage of total output for industrial companies, with SOEs as a whole contributing only 11% of the total output of the Chinese economy today.[197] Therefore, while the actions of the party-state in favoring public over private enterprises has hampered the transition of the Chinese economy, the reduction in size of the SOEs in both value-added output and as a percentage of the labor market indicates that SOEs constitute too small of a proportion of the Chinese economy to provide the most comprehensive explanation as to why the Chinese economy has slowed.

However, the related actions of the party-state in showing favoritism of SOEs over private firms bears a clear correlation to the inability of the party-state to transfer out of its path-

[197] Andrew Szamosszegi and Cole Kyle. "An Analysis of State−Owned Enterprises and State Capitalism in China." *U.S.-China Economic and Security Review Commission*. (2011): 14.

dependency on an input-based model. In this sense, the problems are related, in that the inability of the leaders of the party-state to reform public enterprises is strongly connected to the party-state's ability to transition the economy out of an input-led model of growth. To accomplish the transition from an input-based model to a more market-oriented, advanced and diversified economy, the party-state must be able to overcome the institutional barriers of path dependency and change its approach towards both an input-based model and credit allocation.

Finally, the politburo and LSGs of the party-state under Hu Jintao and Xi Jinping have routinely put forth various policy proposals aimed at transitioning the economy to a more advanced and diversified model of growth. But as evidenced by the current state of the Chinese economy, these policies have never fully succeeded. This further shows the deeper, institutional impediments facing the party-state. For example, senior officials within the party-state have put forth plans for the reform of SOEs since 1991. Yet these plans have not had any demonstrated successful impact on the reform of SOEs, as evidenced by the lack of success in these reforms and the continued allocation of credit towards zombie firms. The problem is not that the leaders of the party-state are not attempting to make reforms, but that mid- and lower-level officials are creating and perpetuating institutional barriers against the successful implementation of these reforms. This problem is rooted in the lack of motivation to implement these policies by lower level actors within the party-state. These actors all currently benefit under the input-led model, and may not reap as many immediate benefits under a model that calls for a shift away from the current government control over the economy. Consequently, individual motivations of these actors within the party-state keeps the Chinese economy on a model of path dependency of an input led model.

Under Xi Jinping, the leaders within the party-state appear to be more forcefully attempting to transition the Chinese economy. While this attempt has been orchestrated through the interplay of a variety of different channels, it is unclear if this transition will be successful. The following paragraphs will outline both the means utilized by the leaders of the party-state in an attempt to orchestrate this change, and also the likely points of contestation. They will conclude with a predictive analysis of the likelihood that the proposed policies and reforms will be implemented successfully.

In his seminal economic policy, Made in China 2025, Xi Jinping outlines in broad strokes his vision for the next model of growth for China. The policy focuses on the cultivation of innovation domestically and a corresponding increase in the amount of domestic research and design (R&D) as well as service sector jobs.[198] The target of the policy is broad, encompassing automotive, aviation, machinery, robotics, high-tech maritime and railway equipment, energy-saving vehicles, medical devices, information technology, as well as smaller, but still significant industries.[199] Further, because the Chinese domestic economy does not posses the technological capacity to alone drive this innovation, the party-state has included within the Made in China 2025 plan tangible steps aimed at increasing China's domestic technological capacities.

The Made in China 2025 plan is supported by substantive capital investments allocated through designated channels within the party-state. At the national level, the Advanced Manufacturing Fund and National Integrated Circuit Fund were allocated 20 billion CNY (USD

[198] Jost Wübbeke et. all. "Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries." *Mercator Instituite for China Studies,* 2(2016, December): 6.

[199] Ibid.

$2.7 billion) and 139 billion CNY (USD$19 billion) respectively.[200] This national level investment is complemented by local investment, in which local *guanxi* networks and favoritism are more likely to direct the specific directionality of funding. While these investments are allocated throughout a variety of sectors, particular focus is to be given to companies with an ability to promote domestic jobs in manufacturing, the service sector, and research and development. In this way, the plan appears to be attempting to form a model of South Korean *chaebols,* like Samsung for the Chinese economy. Like Samsung, an aim would be for these large, service-based companies to be able to drive innovation and to facilitate diversified domestic economic growth.

Party-state leadership has designated capital outlays for these projects to be accomplished, but a substantial policy weakness that may frustrate its success is that the fundamental mode of implementation is unchanged. The implementation of the policy goals still follows a top-down model of delegation, making it more likely that the Made in China 2025 plan will encounter many of the same institutional restraints of path dependency that have contributed to the failure of previous reform initiatives. For instance, subordinate bureaucrats within the party-state have more to lose in the implementation of the Made in China 2025 policy plan than they have to gain in the short term. This makes it unlikely that they would readily facilitate the adaptation of these plans. Mid-level leadership of the party-state have more to gain from the successful implementation of changes. But aspiring members of the party-state who wish to impress Beijing can also gain admiration through the accomplishment, at least on paper, of further economic growth, or the successful implementation of other policies. While officials

[200] Jost Wübbeke et. all. "Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries." *Mercator Instituite for China Studies,* 2(2016, December): 7.

overall may use the plan to gain access to capital, it is unlikely that they would break the mold of their path-dependent role within the party-state to attempt to implement such drastic changes. This likely will make the actual success of the Made in China 2025 policy a relatively low priority for the majority of the officials within the party-state, with the exception to this being high level officials who have conceived and are advocating for wide adoption of these policies.

This conflict between the goals of the senior leadership and lower level officials within the party-state can be seen in other areas of reform as well. For example, the publication of a series of letters on the front page of the People's Daily penned under the pseudonym, An Authoritative Personage, over the course of 2016 criticized the loose capital controls and highlighted the dangers and instability of China's current growth model.[201] In this manner, the letters highlight the tension between these conflicting goals. The publication of the letters sent shockwaves through the party-state, as it was unclear to what extent the letters would impact future mechanisms of economic growth.[202] Consequently, while senior officials both realize the need to constrain the continuation of an input-led model of growth and transition the Chinese economy into a more advanced and diversified economy, the lower-level bureaucrats have different, if not competing motivations. Therefore, until the lower-level bureaucrats have a motivation to transition out of the input-based model of growth, it is unlikely that either the letters from An Authoritative Personage or the policy proposals within the Made in China 2025 plan will have any definitive impact on the trajectory of the Chinese economy.

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[201] Xin Zhou. "China Heading for Big Economic Policy Shift, Says Mystery 'Authoritative' Source in People's Daily" *South China Morning Post,* May 30, 2016.

[202] Ibid.

Consequently, because of the persistence of the competing motivations for higher and lower level party-state officials for economic policies, it is unlikely that China will transition away from its current model of growth in the near future. China was able to transition into this model under Deng Xiaoping because of the clear motivations of all officials to transition into the input-based model. However, the immediate benefits of the input-led system outweigh the potential future benefits of a more economically advanced and diversified economy for lower-level party-state officials.

Therefore, it appears that there are only two plausible modes of economic transition within China. In the first, the lower-level officials are motivated to enact changes on a localized level. In this bottom-up model, the change starts at the lowest level and moves up the ranks of the bureaucracy while simultaneously spreading across China. While there are few examples of this policy approach for China, there exist some similarities between this theoretical model and the housing market policies, or changes in *hukou* registration throughout China. For the latter, it is often postulated by scholars such as Martin Whyte that the party-state operates on a model of preventing the explosion of a 'social volcano.'[203] Under this pretense, the recent reforms to the *hukou* system of registration in which individuals can exchange rural *hukous* for urban *hukous* can be seen as a response to the shifting generational needs, as factory workers in cities have demanded increased access to social services. While both these demands and corresponding experimentations with the transfer of *hukou* registrations began on a local level, it is likely that the higher levels of the party-state saw the utility of these policies as a mechanism of preventing social disturbances, and were thus more motivated to implement the policies on a national level.

[203] Martin King Whyte and Dong-Kyun Im. "Is the Social Volcano Still Dormant? Trends in Chinese Attitudes toward Inequality." *Social Science Research* 48 (2014): 62-76.

The second approach of economic transition presumes that the only feasible way for an economic transition to occur were if China was to experience an extreme detrimental shock that shifted the motivations for the implementation of economic reform policies to the lower level members of the party-state. Under this model, the event would have to be so severe as to dramatically shift the motivations of the lower level members of the party-state to see the future implementation and existence of a more advanced and diversified economy as superior to the current input-based model of growth. While this could potentially take the shape of a dramatic economic recession in which capital input dramatically failed or the stability of the party-state's control was threatened, this scenario appears to be unlikely.

Consequently, while the current 6.5% growth rate of the Chinese economy is admirable, and well above that of other nations, the reality is that the composition and state of the Chinese economy cannot be shielded behind a positive GDP growth rate. China is likely to enjoy continued rates of growth that are relatively high compared to other nations and will continue to be a one of, if not the largest, economy in the world. However, it is unlikely that the Chinese economy will be able to sustain its current growth model for a protracted period of time given the inability of the party-state to adapt its economic policies to the changing structure and needs of the Chinese economy and population. Therefore, the slowing of the Chinese economy can be chiefly attributed towards the inability of the party-state to shift away from an input-based model of economic growth, along with coinciding factors such as the inefficient utilization of corruption and the favoritism of the party-state in public over private firms. While this constitutes the most plausible explanation as to why the Chinese economy has slowed given the available evidence and resources, it is also unlikely that the economy will transition away from this model and eliminate the detrimental impact of these factors in the near future given institutional restraints and government's reliance upon a model of path dependency for decision making.

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