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Brakes on Chinese Development: Institutional Causes of a Growth Slowdown

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Abstract: China has enjoyed spectacular economic growth since the 1980s. Economic models based on production functions typically suggest that China's rapid growth will continue at similarly high rates, but they ignore pressing structural and institutional constraints on its development. Among the problems identified in this paper, we point to an impending demographic shift that will greatly increase the number of economic dependents, the inadequate corporate legal foundation for indigenous private enterprise, and the discriminatory, defective and disruptive system of land tenure. These issues point to a pressing agenda of institutional reform to help China develop in future decades. Reforms have to concentrate on political structures, state efficiency, incentives to educate and train migrant workers, land tenure, and on private enterprise.

Keywords: China, corporate law, demography, development, institutions, land tenure

JEL Classification Codes: B52, J11, K22, O15, O16, O53

After three decades of rapid growth, China is now poised to become the largest economy in the world. A great deal has changed since Mao Zedong died in 1976. Although Mao's regime greatly increased education levels and life expectancy, the economy suffered from the huge disasters of the Great Leap Forward and the Cultural Revolution.[2] In December 1978, under the new leadership of Deng Xiaoping, the Third Plenum of the Eleventh National Congress Central Committee of the Communist Party announced a program of modernization and reform to propel China into the twenty-first century.

Since 1978, China's economic growth has been spectacular. China's real GDP per capita has more than doubled in each of the three decades since 1980. From 1980 to 1990, the GDP per capita grew at an average of 7.6 percent per annum, from 1990 to 2000 this growth was 9.4 percent, and in the first decade of the new millennium

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GDP per capita growth averaged 9.9 percent per annum. In particular, the first decade of the twenty-first century has witnessed a huge structural transformation of China's industry and agriculture, affecting both the public and private sectors.

Many analysts behold a future of uninterrupted growth. One mainstream model of the Chinese macro-economy estimates a Cobb-Douglas production function and has little difficulty predicting growth rates of around seven percent well into the future (Chow and Li 2002). A later and more sophisticated model, likewise based on an estimated aggregate production function, similarly predicts unrelenting growth in Chinese total factor productivity (Song, Storesletten and Zilibotti 2011). Also, on the basis of production function estimates, Nobel Laureate Robert Fogel (2010) has predicted that China's GDP will grow at an average rate of about eight percent until 2040, by which time its GDP per capita would be twice that of Europe and similar to that of the USA.

These models take inadequate account of the institutional and structural problems facing China today. A continuation of current high rates of growth is questionable for several reasons, in addition to the world economic slowdown after 2008. Much of the growth from 1980 to 2000 was powered by the rural sector, following the de-collectivization of agriculture and the development of rural enterprises (Huang 2008). Further institutional changes are needed to address the problems of a rapidly urbanizing market economy. The brakes on future growth derive from a complex of institutional, structural, and demographic factors. To alleviate the coming growth slowdown on the path of development and to avoid impending social instability, China has to urgently address an agenda of deep institutional reform.

China has many such problems, and we do not attempt a comprehensive survey of institutional constraints. Instead, we focus on three broad structural issues: namely (a) demographic shifts and the problem of supporting a larger dependent population; (b) the lack of a developed institutional — legal and financial — foundation for indigenous, advanced private enterprise; and (c) the severe developmental constraints inherent in the existing system of land rights and residency registration.

The remainder of this paper is organized in five sections. The next section addresses the problems of Chinese demography and its growing educational and welfare needs. Section two examines the corporate sector in Chinese industry and identifies severe inadequacies in the current systems of corporate law and business finance. Section three addresses the rural land tenure system and the problems generated by the rural-urban divide. It identifies the land problem as a major and growing source of political instability in China. Section four sketches an agenda of institutional reform. Section five concludes the paper.

The reforms we advocate in this paper involve a combination of state and private measures. State administration has to be made more efficient and even extended in some spheres, particularly concerning taxation, corporate regulation, and the implementation of law. Some property rights have to be reinforced or extended, while inequalities and injustices have to be addressed to minimize the possibility of explosive confrontation.

Demographic and Fiscal Drag

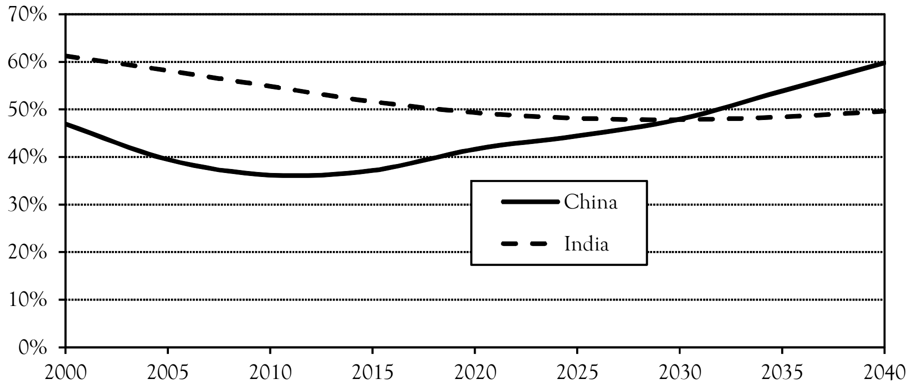
Some brakes on China's future growth result from the changing age structure of the population and its impact on the underdeveloped fiscal and welfare system. China's one-child policy was introduced in 1978 and has dramatically reduced the birth rate. It is estimated that, in 2010, 0-14 year-olds constituted 17.9 percent of the overall population. At the same time, despite China's growth in the past three decades, factors such as the underdevelopment of the health system have also resulted in a low proportion of seniors. It is estimated that, in 2010, those of 65 years or more comprised 8.7 percent of the overall population. Hence, those of 15-64 years of age made up 73.4 percent (U.S. Census Bureau 2011). The 15-64 age group is of working age and must generate most of the income and taxes to sustain the younger and older groups. The standard definition of the dependency rate is the sum of the percentages for seniors and children, divided by the percentage for the 15-64 year-old group. The dependency rate, in 2010, in China was 36.2 percent. This means that each person of working age must, on average, sustain 0.362 other people. This is much lower than in most other countries of a similar level of development. But the situation is changing dramatically.

Jointly with other factors, demographic structures are major predictors of productivity and growth differences between nations and through time (Feyrer 2007).[2] Growth does not correlate with demographic factors alone, but dependency rates indicate a "burden" that income-earning workers unavoidably must carry. As they develop, countries often enjoy a "demographic dividend" for a while, with low dependency rates. Around 2010, China had one of the lowest dependency rates in the developing world.

Demographic projections, published by the U.S. Census Bureau, provide the raw data we use to construct Figure 1. Such predictions can be inaccurate. The U.S. Census Bureau assumes that fertility and mortality rates remain constant. On this basis, in 2030, China's dependency ratio will be about 48 percent and rising, while India's will be at roughly the same level, after falling from much higher levels. By 2040, India and China will swap their 2000 positions, and China will have lost its current demographic advantage.

In China's case, there are two strong forces pushing for an even further rise in the dependency rate than shown in Figure 1. The first is the potential future relaxation of the one-child policy. There are already cases where this policy does not apply, such as to ethnic minorities (registered at 8.49 percent of the population in the 2010 census). In rural areas, couples are sometimes allowed without redress to have a second child if the first is a girl. Today, in many urban areas, if the mother and father are both children of a one-child family, then they are sometimes permitted to have two children. As many Chinese couples increase their incomes, some of the better-off opt to pay the fines for having a second child. There is currently a political debate concerning the one-child policy. If the Chinese government liberalizes, or makes concessions to enhance its popularity, then the one-child policy is likely to be relaxed or even scrapped. This would put additional upward pressure on the dependency rate until the additional children became of working age.

Figure 1. Dependency Rates in China and India



Note: Calculated from data of the U.S. Census Bureau 2011.

China's population is aging at a relatively rapid rate. The percentage of seniors is expected to rise further as China develops and its health services improve. This is the second source of upward pressure on the dependency rate. For all the above reasons, by 2030, it is likely that the dependency rate will increase to over 48 percent, reaching over 60 percent by 2040. On the other hand, these demographic shifts would not make China's dependency rate larger than the norm in many developed countries. (Dependency rates in the USA are projected to reach about 80 percent in 2030.) But no developed country is growing at anything like China's current breakneck speed.

Expected further increases in labor productivity will mean higher earnings, and will allow greater tax revenues. But countries with much higher levels of labor productivity than China spend a much higher proportion of their incomes on welfare and education. To develop further and to deal with the demographic changes, China must also raise dramatically its revenues for welfare and education.

A key institutional problem for China is developing tax systems to finance the increasing dependency rate. Before the 1980s reforms, the central government received large revenues of surpluses from state-owned enterprises. Subsequent privatizations have reduced the size of that sector and the government has had to turn more and more to the taxation system for revenue. Revenues were falling until they reached a low level of 10.8 percent of the GDP in 1995. The deep reforms to the tax system in 1994 dramatically reversed that trend.

By 2009 government revenue was 20.1 percent of the GDP and tax revenue was 17.5 percent. The major components of the latter were value-added tax of 5.4 percent, business tax of 2.6 percent, consumption tax of 1.4 percent, tariffs of 0.4 percent, corporate income tax of 3.4 percent, and individual income tax of 1.2 percent. Hence tax income from individuals or their consumption amounts to a mere 8.0 percent of the GDP (National Bureau of Statistics of China 2011). There is also a growing government indebtedness.

China's grossly inadequate fiscal arrangements face growing challenges, including the need for increased expenditure on education and health, as well as welfare payments to the unemployed and to the growing number of pensioners. Currently, the pension system is urban-biased, far from universal, and covers only a small fraction of the rural workforce. By 2010, in fifteen provinces, the revenue from pension insurance funds was much less than the required expenditure. Lacking major reform, the pension system cannot survive without large financial subsidies (China Human Resources and Social Security Publishing Group 2011).

China's fiscal and social security institutions are currently ill-equipped to deal with the projected rise in the dependency ratio. Without further dramatic reform and a big increase in tax rates, the population will have to fall back on traditional modes of supporting the old or infirm from within the family, thus restricting participation in the waged workforce of the 15-64 age group.

Post-reform household saving rates in China are very high, reaching 33.7 percent of income in 1994 and 23.6 percent in 2000. High savings reflect both the rapid recent growth in incomes and personal financial insecurity in the face of the underdeveloped social security system. Among the stated reasons for these high savings rates is to finance retirement (Modigliani and Cao 2004). But prudent as it may be for households, saving reduces aggregate effective demand for goods and services.

The Chinese government faces the pressing problem of reforming and expanding the pension and benefits system, alongside an equally urgent need to reform and expand its tax-collecting institutions. Dramatic tax increases are likely to be unpopular, unless the working population can be convinced that they are for their own future benefit. Ultimately, therefore, these problems are political, as well as administrative, economic, and demographic.

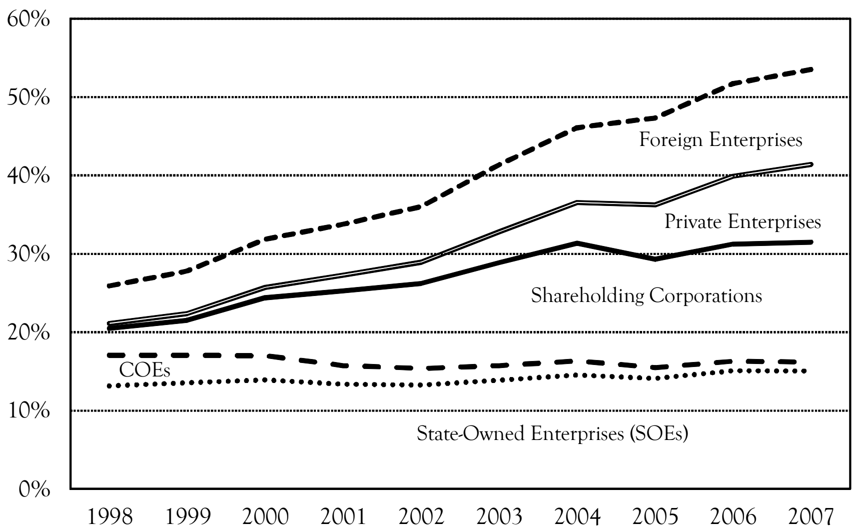
A danger is that China will suffer a demographic "Dutch disease," where the temporary advantages, resulting from the one-child policy and from the temporarily low proportion of seniors, lead the authorities to overlook the urgency of reforming and expanding the pension and social security system to deal with much higher dependency rates in the near future.

Corporate Impediments

Much of China's economic growth from 1978 to 2000 emanated from the rural sector (Huang 2008). The de-collectivization of agriculture and the development of some rural industry — including the innovative "town-village enterprises" (TVEs) — drove much of China's expansion in the 1980s and 1990s. But China has also become rapidly urbanized, and future economic growth will depend more on urban industry and services. In 1980, about 19 percent of the population resided in urban areas. In 2010, the urban population was estimated at about 47 percent.[3] Rural development remains important for China's growth, but it is no longer the principal engine of transformation. The organizational loci of growth have shifted from the rural townships and TVEs to private and state-owned enterprises in urban areas.[4]

Figure 2 shows the recent dramatic change, in the few years from 1998 to 2007, of the percentage contribution of different types of industrial enterprise to China's GDP.[5] Enterprise contributions are measured in value-added terms. Note that the figures in Figure 2 are vertically *cumulative* in any given year. For example, the 53.5 percent overall figure in 2007 is the cumulative contribution of *all* types of industrial enterprise, not simply foreign enterprises.[6]

Figure 2. Cumulative Percentage Contribution of Different Types of Industrial Enterprise to China's GDP



Source: National Bureau of Statistics of China (2010).

In part, these changes reflect a rapid growth of urban enterprise, but the growth of non-agricultural rural firms has remained important, and the proportions in the figure are not confined to urban areas. The figure shows the contributions of state-owned and state-holding industrial enterprises (SOEs), collective-owned enterprises (COEs), shareholding corporations, private enterprises, and foreign enterprises (including those from Hong Kong, Macao, and Taiwan).[7] The residual proportion of the GDP — which is mostly attributable to family farms, agricultural enterprises, and service sector enterprises — has shrunk from 74.1 percent to 46.5 percent in ten years. By contrast, the foreign, private, and shareholding enterprises have markedly increased their portions of a rapidly growing cake.

Consider the official definitions of each type of enterprise, according to the National Bureau of Statistics of China (2010). SOEs refer to a mixture of forms, principally state-owned enterprises, state-funded corporations, state-holding enterprises, and state-owned joint-operation enterprises. With state-holding enterprises, the percentage of state assets (or shares held by the state) is, by definition, larger than any other single shareholder in the same enterprise.

COEs refer to non-state enterprises with collectively owned assets. They include urban and rural enterprises with collective investments, and some registered cooperatives with pooled individual capital. The TVEs were placed in the COE category. Many COEs today are other kinds of rural enterprise, owned by town and village committees. Of the five types of enterprise we consider here, COEs are the least important and their GDP share has declined markedly.

Shareholding corporations are registered joint-stock units with their capital divided into shares. They include both private limited companies and limited companies with publicly floated shares on the stock market. The legal liability of investors is limited to their shareholding. The 2005 Company Law requires that a minimum amount of the registered capital of a joint-stock limited company is RMB 5,000,000 (about US$800,000), and that at least half of the company sponsors are domiciled in China. The corporation must apply to the Securities Regulatory Authority under the State Council for permission to issue its shares on the stock market.

Private enterprises refer to registered economic units owned by individuals. Included in this category are small private limited liability corporations, private partnerships, and private sole investment enterprises. Figure 2 shows that the most important changes in 1998–2007 were the growing shares of China's GDP attributable to foreign, private, and shareholding enterprises.[8] These forms of enterprise seem to be taking a dynamic lead. But this would be a superficial judgment for several reasons. To get a better picture, we need to look at some further data. Table 1 reveals some additional features and some major transformations. Note first the growth in the average size of SOEs, the small and declining size of COEs, and the relatively small size of private enterprises.

The 2010 clear leaders, both in terms of average size and output per worker, were the SOEs and the shareholding corporations. Yet, in Figure 2, the share of the GDP attributable to SOEs showed only a slight increase from 1998 to 2007. This is a result of many closures and privatizations, and a huge shakeout of labor from SOEs from 1993 to 2007 (Naughton 2007, 106-107, 185-186, 300-301). It was mostly the small and loss-making SOEs that were privatized (Huang 2008, 169). Of the SOEs in existence in 1998, only 31.3 percent of these enterprises were surviving in this sector in 2010. In 1998, about 37.5 million workers were employed in SOEs. This fell to a low of 17.4 million in 2007, but rose slightly to 18.4 million in 2010. Surviving SOEs reformed organizationally and were granted more autonomy, while retaining state ownership.[9]

The focus of surviving SOEs is within the large-scale manufacturing industry, where increasing returns to scale are typical. Much of the production of industrial materials and energy is within SOEs. Most large-scale civil construction — including roads, bridges and the ambitious high-speed railway system — is being performed by large SOEs. The four largest indigenous automobile companies in China — SAIC Group, Chang'an Motors, FAW Group, and Dongfeng Motor — are SOEs. China Mobile is a massive, state-owned, mobile phone company with 600 million customers. Three Chinese state-owned companies rank among the world's ten biggest companies by revenue (*Economist* 2012).

Table 1. Size and Output per Employee by Different Types of Industrial Enterprise

	SOEs		COEs		Shareholding Corporations		Private Enterprises		Foreign Enterprises	
	Mean number of employees	Mean real output per employee	Mean number of employees	Mean real output per employee	Mean number of employees	Mean real output per employee	Mean number of employees	Mean real output per employee	Mean number of employees	Mean real output per employee
1998	579	25.2	no data	no data	no data	no data	151	36.4	293	60.8
2004	554	88.2	688	38.1	659	120.1	127	57.5	293	93.2
2010	907	189.3	189	102.9	644	193.7	121	120.5	357	134.3

Sources: China's National Bureau of Statistics (2004, 2006, 2010, 2011). Mean real output per employee is in 1,000 RMB per annum in 1978 prices.

SOEs benefit more than other enterprises from state favoritism and state industrial policies (Huang 2008, 169-170). There is also evidence that SOEs have relatively easier access to finance from the largely state-owned Chinese banks (Boyreau -Debray and Wei 2005). The SOEs also received a large financial boost from the 2008 –2009 four trillion RMB (US$ 590 billion) stimulus package to mitigate the effects of the global economic and financial crisis. Although this package helped enterprises of all types, SOEs benefitted especially as a result of its large-scale industrial and infrastructural features. In 2009, some 85 percent of China's US$1.4 trillion in bank loans went to SOEs (*Economist* 2012).

Increased efficiency is manifest in the sector as a whole. Output per worker in the SOE sector has increased by a huge factor of 7.5 from 1998 to 2010, making average output per worker in SOEs comparable to that in private shareholding corporations. Statements that SOEs are "less productive" (Song, Storesletten and Zilibotti 2011, 208), or have "lower productivity" (OECD 2011, 13) are out of date, at least in terms of gross output per employee in 2010. But the overall productivity increase in the SOE sector is largely due to the elimination of the less efficient firms from this sector. The gains in productivity of individual SOEs are much less impressive. Although surviving SOEs perform as effectively as many private firms, questions arise concerning future improvements in SOE productivity, especially if SOEs were to operate alongside other types of enterprise on a more level-playing field. Furthermore, large productivity improvements, gained by culling the less efficient firms from this sector, may also be more difficult to achieve.[10]

Figure 2 and Table 2 show that the fractional contribution of industrial SOEs to China's rapidly growing GDP increased very slightly from 1998 to 2007. This means that industrial SOE output grew slightly faster than China's GDP as a whole. But the contribution of SOEs to China's export performance has declined in fractional terms. The share of China's exports produced by SOEs fell dramatically from 66.7 percent in 1995 to 19.7 percent in 2006. Other forms of enterprise now account for the lion's share of China's exports.

We turn to non-foreign, private, and shareholding enterprises. These account for rapidly rising shares of China's GDP. Shareholding enterprises are, on average, much larger than firms categorized as private enterprises. Shareholding industrial enterprises were responsible for 3.5 percent of the GDP in 1998 and 15.3 percent in 2007. Private industrial enterprises were responsible for 0.6 percent of the GDP in 1998 and 9.9 percent in 2007. In ten years, industrial private and shareholding firms, together, have grown from about four percent to about a quarter of the Chinese GDP. They have also made impressive gains in output per worker, without relying on the culling effect observed in the SOE sector.

On the other hand, their export performance has been less impressive. While private and shareholding industrial firms made up about 23.6 percent of the GDP in 2006, their share of exports was 17.8 percent. While the 2006 export share of SOEs was still higher than their share of the GDP, the export share of private and shareholding enterprises was significantly lower than their GDP share. Yet, by conventional wisdom, it might be expected that this young and dynamic private sector should be at the vanguard of China's export performance. Business writers, such as Donald N. Sull (2005), extoll the "trailblazing" performance of private firms in China. In fact, private and shareholding Chinese firms are punching below their weight in export markets.

Table 2. GDP Shares and Export Shares of Different Types of Industrial Enterprise

	SOEs		Private & Shareholding		Foreign Enterprises	
Year	GDP share	Export Share	GDP share	Export Share	GDP share	Export Share
1995	no data	66.7	no data	0.0	no data	11.7
1996	no data	57.0	no data	0.0	no data	15.7
1997	no data	56.2	no data	0.0	no data	17.1
1998	13.1	52.6	4.1	0.1	4.8	20.0
1999	13.5	50.5	5.3	0.3	5.4	22.2
2000	13.9	46.7	8.7	1.0	6.1	23.8
2001	13.4	42.6	11.5	2.0	6.5	25.9
2002	13.2	37.7	13.6	4.2	7.1	29.5
2003	13.9	31.5	17.1	7.9	8.5	33.3
2004	14.5	25.9	20.2	11.7	9.5	36.1
2005	14.1	22.2	20.8	14.7	11.1	38.4
2006	15.1	19.7	23.6	17.8	11.8	39.5
2007	15.0	no data	25.2	no data	12.1	no data

Sources: Wang and Wei (2008, Table 2); China's National Bureau of Statistics (2010).

By contrast, the foreign firms in China have a higher export share than their share of the GDP. China joined the World Trade Organization in 2001, and this opened the door further for foreign direct investment. Overall, the share of China's exports produced by foreign-owned firms increased from 11.7 percent in 1995 to 39.5 percent in 2006. From 1998 to 2006, their contribution to China's GDP increased from 4.8 to 11.8 percent. The role of foreign firms in the contemporary Chinese economy is ironically redolent of the pre-1949 colonial period, when foreign concessions in Hong Kong, Shanghai, and elsewhere were China's trading gateway to the outside world.

What is happening to prevent the growing domestic private firms, exporting at levels comparable to their share of the GDP? Of course, some of these differences may stem from different sectors having different mixes of exportable and non-exportable goods. For example, domestic construction projects, by their nature, cannot be exported. But we suspect that these differences explain a relatively small part of the divergences.

Differences in export performance are also likely to reflect differences in capacities to access wider domestic markets. Also, private and shareholding enterprises have insufficient access to finance to invest in international marketing and exports. Furthermore, the private and shareholding enterprise sectors have not yet developed sophisticated forms of corporate organization and governance. In the absence of adequate legal measures of contract enforcement, much private enterprise is reliant on trust relations generated through extended family and clan ties (Boisot and Child 1996; Greif and Tabellini 2012; Wank 1999). Clan-based business hinders the development of a modern competitive market economy and partly explains the limited development of China-wide markets. Although there were major reforms to corporate law in China in the 1994–2006 period, the legal security of company investments and the fair enforcement of existing company legislation remain matters of concern for both businesses and the political authorities. Many functioning Chinese firms lack an adequate legal foundation, creating problems of contract enforcement, legal liability and enterprise accountability (Clarke 2005). High levels of public and private corruption in China undermine the proper functioning of public administration and the legal system, and create further impediments to fair competition.[11]

Despite its rapid growth, contemporary China lacks coherent, uncorrupt, and impartial legal mechanisms for private businesses. Instead, there is a reliance on personal, political and clan connections, appeals to personal honor while shaming defaulters, the use of networks fostering reciprocity and reputation, and recourse to local political officials. The financial, organizational and legal structures, required to support private exports, are highly underdeveloped and they are holding back China's export growth.[12] Unfortunately, the required institutional changes will inevitably be slow and difficult to achieve.

As Peter Nolan (2004, 20) points out, "[t]he blunt reality is that after two decades of reform China's large firms are still far from being able to compete with the global giants. The gap is especially marked in the high-technology sectors." Barry Naughton (2007, 325) similarly notes that "so far China has produced only a handful of firms that approach international best practice in corporate governance."

Naughton continues: "The firms on everyone's short list include Lenovo the computer company; a few telecommunications equipment firms, Huawei and ZTE; and a few producers of consumer durables such as Hai'er." But this "short list" reveals another matter of concern. None of these four firms is typical of the Chinese private enterprise sector in terms of shareholding or corporate registration.

Listing several Chinese corporate "trailblazers," Sull (2005) wrongly describes Lenovo, Sina, UTStarcom, AsiaInfo, Hai'er, Galanz, Wahaha, and Ting Hain as straightforwardly Chinese enterprises. The facts are different (Huang 2008, 1-12). Lenovo is registered in Hong Kong, not in mainland China, and is thus subject to a British-derived system of corporate law. Huawei has an opaque ownership structure and is subject to defense-related secrecy. Hai'er is not itself a foreign company, but its main business and production subsidiaries are abroad. ZTE is a Chinese company, but it is registered in Shenzhen — a partly autonomous, special economic zone with a more business-friendly legal and financial environment. Leading "Chinese" firms such as Sina, UTStarcom, Ting Hain, and AsiaInfo are wholly owned foreign investor enterprises. Galanz and Wahaha's main business and production subsidiaries are foreign. As Naughton (2007, 417) notes, "[o]f the top ten firms in China exporting high-tech products in 2003, nine are foreign – four from Taiwan and five from the United States." Domestic hi-tech firms have performed less well. For example, the Great Wall Group operated within China's domestic business environment but "foundered badly" (Huang 2008, 5).[13]

The role of the domestic stock market in generating capital and allocating resources in the economy has been "limited and ineffective" (Allen, Qian and Qian 2008). The state-run banks offer relatively low interest rates, and illegal private banks have proliferated, offering higher but more risky rewards. Financial resources for private business are scarce, and fundraising outside the state-dominated banking system still carries the death penalty.[14]

Crucially, outside registration gives more autonomy and more reliable legal protection for many leading "Chinese" private firms.[15] Otherwise, many dynamic and seemingly private firms in China are still part-owned or controlled by the state. "By the end of 2004 there were 1,377 firms listed on the markets in Shanghai and Shenzhen, most of them were still government controlled" (Naughton 2007, 469). Control and ownership structures in China are so complex that it is difficult to disentangle the public from the private. There is a plethora of business types firms: nationally owned, local government owned, nationally controlled private, local government controlled private, and privately owned and controlled (Huang 2008: 13-26). Many successful "private" firms in China are foreign-owned or state-controlled. The contribution of genuinely private Chinese firms is less than it appears at first sight. Part of the problem is the lack of adequately developed legal and other institutions to support independent private enterprise.

Firms operating in China but legally registered in Hong Kong, Macau, or Taiwan are the stars of China's export performance. We have noted that the share of China's exports produced by foreign-owned firms increased spectacularly in a few years to reach 39.5 percent in 2006, while their contribution to China's GDP was 11.8 percent in that year. One author describes China as a *leader of the world economy* (Chow 2011). China's economic performance has been stunning. But in terms of the development of corporate governance and corporate law, which are necessary for future development with a secure and innovative private sector, China remains a lackluster follower rather than a global leader.

Land Institutions and the Rural-Urban Divide

In December 1978, in the same month of the reforming Third Plenum of the Communist Party, farmers from eighteen households in Xiaogang village in Anhui Province secretly adopted a system where each household would take responsibility for its own parcel of land and take ownership of its outputs (Zhou 1996). Although the Third Plenum did not propose the de-collectivization of agriculture, the new climate of reform encouraged illegal experimentation with the new "household responsibility system" (*baochan daohu*). The results of this new system were so astonishing that a national decision was reached in 1980 to legalize the household responsibility system in the poorest communes. The gains in output and incomes were so spectacular that it was impossible to prevent the further spread of the new system. Most agricultural communes had disappeared by the end of 1983. China's agriculture was de-collectivized.

This single reform in land-use rights, triggered by changes at the top and powered by pressure from below, transformed Chinese agriculture, brought millions out of destitution, and set the country on its post-1980 path of rapid development. But the rural land was still owned by the village collectives, and remains so to this day (Ho 2005). Although agricultural de-collectivization radically altered China's economic fortunes, institutional residues of the collectivist period still have profound and sometimes deleterious effects on China's economic and social development. The Chinese government has made the development of rural areas and remote regions a priority. To some extent these policies have been successful, particularly through the extensive development of transport infrastructure. But huge regional inequalities and a large urban-rural gap remain (Sicular et al. 2007).

The gap between urban and rural areas and their inhabitants is institutionalized in the household registration system, or *hukou*. Redolent of residence permits in ancient China, the modern version of this system was established in 1958 during the development of the command economy, primarily to control the movement of labor between rural and urban areas. According to the *hukou* system, every Chinese citizen has a registered principal residence and a registered status as a rural or urban citizen (Chan and Zhang 1999). Against Article 33 of the constitution of the People's Republic of China (2004), which declares that all citizens "are equal before the law," the *hukou* system divides the Chinese population into two classes, according to registration at birth. Urban and rural citizens have different rights and entitlements. It is possible but difficult to change from rural to urban status.

Apart from controlling population movements, the *hukou* system obliged rural residents to work in the agricultural collectives. After de-collectivization in the 1980s, this obligation was converted ostensibly to the right to use land, which is owned and allocated by village committees. Contrary to some commentators (Nolan 1993, 74; Zhu and Jiang 1993, 447), this does not necessarily mean that land property rights are "vague" or "unclear." In legal theory there are several different types of property right (Honoré 1961). In China, rights of sale and transferability are unambiguously in the hands of local or national state institutions. By contrast, Chinese farmers do have benefit-of-use rights (*usus fructus*), but these rights are currently not saleable or transferable. These land-use rights are typically buttressed by complex arrangements of local power. Use rights are sometimes curtailed through expropriations or compulsory purchase with little compensation. The greater problems lie with the security of some property rights, rather than with their vagueness.[16]

It must not be overlooked that the de facto devolution of viable land-use rights to local farmers was the powerhouse of the 1978–2000 reform and growth (Oi 1999). The position of China is complex, but we need clear concepts to understand it. Any good argument that clear property rights matter less than their proponents claim cannot be based on unclear or conflated notions of what property rights are. It is necessary to distinguish between possible imperfections of practical legal definition by the authorities, imperfections of allocation, and imperfections of enforcement.

Following 1988, systems of election of village committees were established in many provinces, marking a significant extension of local democracy (Wang 1998). Through the village committees, rural registrants often have land-use rights that are not extended to urban registrants. On the other hand, urban registrants are entitled to the better-paid jobs, education, housing, and healthcare, most of which are unavailable to those with rural registration. The *hukou* remains as one of the most important determinants of differential privilege and social stratification.

Some relaxations of the *hukou* system have been introduced since 1980. By the 1990s, it had become possible for rural residents to buy temporary urban residency permits, thus giving them the option to work legally for a while in the cities. Further reforms in the first decade of the new millennium were interpreted by some as a dismantling of the system. In fact, they amounted to the devolution of responsibility for *hukou* administration to local governments, which could in some cases make permanent migration of peasants to cities harder than before (Chan and Buckingham 2008). Yet, in early 2012, the national government announced that rurally registered residents of medium-sized cities could convert to urban registration after three years of residence.[17]

The *hukou* system is put under pressure by the growing Chinese urbanization and transformation of the rural areas (Goldman Sachs 2011). The failure to develop an efficient and adequate taxation system means that local governments resort to land seizures and sales to gain revenue. Farmers sometimes collude in these arrangements, seduced by large one-off payments by the local authorities. The modernization of farming practices, land seizures by the state, and the closure of inefficient SOEs and COEs in rural areas, have left a huge rural population looking for work. Furthermore, the wide discrepancy between rural and urban incomes has spurred rural workers to move to the cities.

Consequently, China is now experiencing the largest mass migration from the countryside to the cities in any country in history. An estimated 230 million Chinese – about seventeen percent of the entire population – have migrated to the cities in recent years. The number is expected to surpass 300 million by 2025 (China Labor Bulletin 2011). But this is no ordinary developmental migration. The migrants are registered second-class citizens in their own country, with inferior access to education and healthcare, and no permanent rights of urban residence.

Migrant workers are usually given labor-intensive, low-skill jobs. The rapidly expanding Chinese cities provide many opportunities for work on construction sites and heavy industry. But this relatively uneducated and unskilled workforce is unsuited for cutting-edge jobs in a growing knowledge-intensive economy. Because of their migrant status, there are lower incentives for firms to invest in the development of their skills. Under current institutional arrangements, few of these migrants attain post-elementary educational qualifications. As rural registrants, they often retain a rural orientation and a desire to send money back to their extended family in their village. The institutionalization of their inferior status denies the Chinese economy access to an enormous source of potentially skilled labor and entrepreneurial drive.

In the rural areas, the *hukou* system is coming under severe strain. Rural development, rural industry, and rapid urbanization eat into the available agricultural land, displacing many more rural residents. To understand the institutional constraints, we first need to consider the legal and constitutional situation in more detail. A relevant extract from the constitution of the People's Republic of China (2004) reads as follows:

> Article 10. Land in the cities is owned by the state. Land in the rural and suburban areas is owned by collectives except for those portions which belong to the state in accordance with the law … The State may, in the public interest and in accordance with the provisions of law, expropriate or requisition land for its use and shall make compensation for the land expropriated or requisitioned. No organization or individual may appropriate, buy, sell or otherwise engage in the transfer of land by unlawful means. The right to the use of land may be transferred according to law.

The rural collectives distribute land-use rights to local farmers. The collectives are responsible for monitoring land use, and have the power to allocate land for housing and local industry, as well as agriculture. Furthermore, under Article 10, the state has the right to expropriate or requisition land from rural collectives "in the public interest." Major problems here are that the compensation level is very low; there is no clear definition provided of "public interest" in this rural context; and the legal means to challenge a land expropriation are extremely limited.

The increasing frequency of land seizures and the limited legal means to protect local land rights from the over-extended ambitions of local government officials, have led to a growing tide of rural protest. Estimates of the number of protests and demonstrations in China vary, but they have increased dramatically in number since 2000. Some estimates in 2005 put the numbers at around two hundred such protests daily in urban areas, and roughly one hundred daily in villages (Economist 2005). Researchers from the Chinese Academy of Social Sciences report that disputes over land account for 65 percent of what are officially termed "mass conflicts." As much as 73 percent of petitions and complaints filed by farmers are related to land. Problems with low compensation and unsatisfactory resettlement are the main point of discontent. In particular, the report notes that that some local authorities have been grabbing land occupied by rural houses on response to a central government order to set aside arable land to help ensure food security. Many thousands of farmers, whose families have lived in farmhouses for generations, are being relocated to multi-story buildings so that local governments can sell the land to developers for profit.

One of the most serious internal disturbances in China since 1949 was in the large coastal village of Wukan in Guangdong province in late 2011. Residents of

Wukan petitioned the national government in 2009 and 2010 over land seizures. Large-scale protests began in September 2011 after corrupt local officials sold land to real estate developers without properly compensating the farmers. Mass demonstrations led to violent clashes between the locals and the police. The authorities allowed the protesters to select thirteen representatives to engage in negotiations. But five of these were taken into custody, where one died. This sparked an uprising on 14 December 2011. The villagers forced all Communist Party officials and police to flee the area. The village was put under siege by the police and food supplies were cut off. On 20 December 2011 senior provincial officials intervened in the dispute and acknowledged the farmers' basic demands. An investigation was set up. The villagers demanded the return of their farmland, the publication of the village committee's financial records, and a re-election of the committee. The provincial officials admitted to mistakes in handling the grievances and vowed to crack down on corruption.[18] On 28 December 2011, in a statement at a national conference on rural affairs, the then Chinese Premier Wen Jiabao called on local officials to better protect the rights of farmers and ensure they receive a bigger share of profits from the conversion of land to industrial and residential use (Zheng 2011).

Rural China is in a severe and growing crisis, exacerbated by anachronistic institutions, growing pressures of urbanization, poor standards of local governance, and corrupt local officials, benefitting from the increased value of land. Major grievances are fuelling rural discontent (Ho 2005). Apart from the threat to social and political stability, the *hukou* system excludes much of the Chinese population from adequate education and health services. The Chinese economy is thus deprived of hundreds of millions of potentially skilled workers. Increasing demands on the limited supply of suitable land have increased its value, enlarged opportunities for local corruption, and undermined the fragile rule of law in rural areas.

Although agricultural productivity has increased enormously since the 1970s, farming output has to be further increased to deal with a growing and more prosperous population under the constraint of a limited supply of suitable agricultural land. The existing land tenure system does not do enough to facilitate productivity-enhancing investment in modern agricultural technology.

Fernando De Soto (2000) and others have proposed the use of land as collateral for financial loans that, in turn, can be used for agricultural improvements or for creating local businesses to promote rural development. Land collateralization requires a secure system of registration and protection of property rights. Efforts in this direction in other countries have led to some positive results, although collateralization also depends crucially on viable and accessible banking, land registration, and legal institutions. China's current land institutions cultivate corruption rather than the productive collateralization of rural assets. These anachronistic institutions are brakes on development. In the next section, we propose reforms that would permit substantial collateralization without challenging the constitutionally enshrined state and collective ownership of the land.

An Agenda for Institutional Reform

We propose a series of institutional reforms to address the problems raised in preceding sections of this essay. We start with the problems of land reform and the *hukou* system. For reasons of both economic development and human rights, we propose that the *hukou* system should be abolished. Residence rights, and rights to access education and healthcare, should be equal for all Chinese citizens. There should be no discrimination on the grounds of ethnicity or place of birth. The *hukou* system is an unwarranted hangover of China's ancient history and collectivist past. It is a massive institutional constraint on education and the development of workforce skills (Goldman Sachs 2011).

Piecemeal reform of the *hukou* system, as with the steps announced in February 2012, may be second best (Enorth Netnews 2012). The danger is that raised expectations by remaining rural registrants will fuel further discontent in urban as well as rural areas. Changes have to be principled, comprehensive and non-discriminatory.

Abolition of the *hukou* system raises the problems of the distribution of land-use rights among the population and the retention of a viable rural workforce. These problems can be resolved by a one-off distribution of tradable land leases to households in return for current land-use rights. This initial distribution of leases would be free of charge to rural registrants in the first instance only. They could become tradable after phased periods of (say) five-to-ten years. Moves in this direction have been proposed by Joyce Palomar (2002) and the Organization for Economic Cooperation and Development (2011, 17):

> The underlying ownership of the land could remain with the collective but smallholders should be allowed to have ownership rights that are similar to those offered to urban residents. In particular, they should be entitled to fully transferable use-rights to their land that would be inviolable for a period of 70 years. With more secure tenure, the average farm household (which currently possesses use-rights for 0.6 hectare of farmland and 0.06 hectare of residential land) would have considerable assets. In order for farmers to make long-term, productivity-enhancing and income-generating investments on land, enhanced access to medium or long-term credit is key and so farmland use-rights should become mortgageable. With well-enshrined rights, farmers would also receive better compensation when the government acquires their land-rights by using the compulsory acquisition laws.

This OECD statement is welcome but inadequate in terms of crucial detail. It does not call explicitly for the abolition of the *hukou* system, but that is a necessary concomitant of adequate land reform. After taking possession of the land lease, rural families should acquire the same status and equivalent rights of urban registrants. Their land-use rights would then be a result of their leasehold tenure, rather than their former status as rural registrants. This explicit transformation is vital to make the leasehold market work properly and to clarify the practical basis of the system. Abolition of the *hukou* divide and the acquisition of tradable-land leases should be simultaneous operations.

Furthermore, the combination of *hukou* abolition with the distribution of land leases will give rural families some incentive to remain on the land, and slow down the potential migration to urban areas, which creates housing and other problems in urban areas in many developing countries. Overly rapid rural-to-urban migration would quickly become a severe problem if there were no incentives for farming families to remain in rural areas. Additional incentives may also be required to reduce excessive urban drift, such as improved rural health and education services.

Rural workers should acquire the same access to the education and healthcare systems as other citizens, with the important economic consequence of greatly widening the development of a skilled and healthy workforce. The OECD proposal is explicit about the mortgageability of land-leases, but more needs to be said about the development of suitable legal and financial institutions to make mortgaging viable and secure.

The final sentence of the quoted OECD proposal is particularly underdeveloped. Under existing regulations, the provisions for compensation after compulsory government acquisition are severely inadequate and insecure. These current regulations have to be changed to enshrine compensation at a level *equivalent to the market value of the land lease*. This, in turn, implies a fully tradable-land lease system, protected by viable legal institutions with vastly reduced levels of nepotism and corruption. Without these institutional conditions, the rights of farmers and rural residents cannot be adequately protected. Crucial here is the general ongoing reform of the legal system and we return to this point later.

After the phased installation of tradable-land leases, village committees would retain the important role of supervision of the land-lease system. Possession of a land lease would carry the existing constitutional requirement that the land is used effectively and in the public interest. If a rural family wishes to move elsewhere and abandon the land, then they would be required to sell the lease to the village committee or another buyer. General leasehold salability could lead to some concentration of land ownership and the development of agricultural corporations or cooperatives. Along with the mortgageability of land leases, some concentration of leasehold tenure will facilitate investment in agricultural technology and lead to economies of scale. At the end of the period of the lease (say, 70 years) the user rights would return to the village committees, who would then sell a renewed 70-year lease on the rural property market.

What are the alternatives to the above proposal? Any Chinese citizen advocating the further privatization of property rights in land, including extending individual rights of title and sale, would be in clear violation of the Chinese constitution, and hence subject to imprisonment. We think that full privatization of land is neither necessary nor politically feasible, at least at the present time. Moving in the opposite political direction, either by reinforcing the existing system, or returning to land collectivization, is also unviable.

Turning to the problems of corporate reform, a key issue here is the promotion of indigenous Chinese enterprise. As noted above, the home-grown private corporate sector in China is remarkably underdeveloped. This weakness is largely attributable to the recent development of a private sector, a relatively young and primitive legal system, and the lack of a history of corporate legal security. Corporations registered in mainland China require secure rights to minimize fears of illegitimate state interference, punitive taxation, or uncompensated nationalization. Such institutions did not develop in the west until a form of state emerged, with adequate checks and balances and countervailing power (North, Wallis and Weingast 2009). But China cannot simply repeat western history. It must find its own way of developing a viable and independent legal system with secure rights.

A problem is that the current Chinese legal system is too tied up with the central political and administrative authority. As Zhiwu Chen (2003, 455) puts it, "[t]he traditional Chinese view, even as of today, is that the law is an instrument used by the ruler to enforce its power and authoritative control and to maintain social order." China needs to develop a more autonomous legal system that protects rights. We are skeptical of the notion that legal systems can or do develop spontaneously in modern complex societies (Aviram 2004; Hodgson 2009; Sened 1997). But some major changes in political structures are required.

We suggest the devolution of much more of the commercial legal system and the entire matter of corporate registration to the provinces (including current Special Administrative Regions, Autonomous Regions and Direct-Controlled Municipalities). A typical Chinese province has a population in the tens of millions. Within limits, and subject to the supremacy of national law, provincial legislatures should have latitude to experiment with variations in commercial and corporate law. This would result in some inter-provincial competition to host the more dynamic and productive Chinese enterprises. In turn, indigenous corporations would take into account the viability and security of the provincial legal systems when choosing a province in which to register.

The government of the People's Republic of China might also consider introducing at the provincial level a further measure of local democracy. Many village committees in rural areas are already elected democratically, although the procedures are sometimes abused by corrupt local officials. The introduction of democratic provincial government would reinforce the relative autonomy of provincial legislatures and encourage local private business. On the other hand, the experience of the former Soviet bloc countries shows that the introduction of national political democracy does not always result in political stability or improved governance (Hodgson 2006; Weingast 2005). Given that China has no experience in developed democratic institutions, the introduction of democracy at the provincial level might best be staggered and experimental.

With the abolition of the *hukou* system, urban and rural residents would have equal rights to welfare, pensions, and education. The demands on the health and education systems are likely to increase as a result of demographic shifts outlined in the first section. The tax system would have to be reformed and expanded. Alongside the development and equalization of the welfare and education systems, there is a need for adequate provision of legal aid. Without recourse to legal advice and representation, leasehold and property rights will be insufficiently secure. This is especially important for rural workers protecting their land-use rights from confiscation or encroachment by corrupt or overzealous local officials.

A further possibility would be to grant the provinces some discretion over the provision of welfare, education, and legal aid. Insofar as inter-provincial migration is feasible for families and individuals, this would create some competition between provinces to provide better conditions in order to attract workers.

Conclusion

Every capitalist system bears the marks of its own unique history. China has to find its own path of development, and it should not aim to imitate western (or, more specifically, Anglo-American) institutions in all their detail. But China can learn from the institutional experiences of other capitalist countries and the histories of their development.

Institutional stasis is not an option. China must develop a full program of institutional reforms, allowing some scope for provincial and other local experiments. Otherwise, it will face huge problems and its development will be arrested. China needs to develop adequate welfare and pension provision for an ageing population, a country-wide and inclusive education system to create a larger pool of skilled labor for a modern knowledge-intensive economy. It also has to establish an adequate system of corporate law and corporate finance to protect and encourage indigenous private business.

In developing parts of a modern market economy we are not suggesting that China surrenders to laissez faire. Much of China's economic success is attributable to the strategic role of the state in the economy, alongside the development of incentives for private and public enterprise. There is little doubt that in a few years China will become the largest economy in the world in terms of overall GDP. But growth rates in excess of seven percent per annum are unlikely to be sustained in future decades. The institutional and demographic problems that we have raised here suggest that growth may slow down even more rapidly than anticipated. Given these problems, one possible scenario is that China slows down by about 2025 to an annual growth rate of (say) five percent. By 2040, its growth rate may be even lower and closer to that found in developed countries. In this case, it will have great difficulties — even after several decades — approaching levels of the GDP per capita that are found in the developed world. It will remain the largest in terms of GDP, but a much less impressive laggard in terms of GDP per capita.

Notes

1. In China, from 1950 to 1965, life expectancy at birth did not rise above 44 years, but it rose steeply thereafter, reaching 66.3 in 1975–1980 and 70.8 in 1995–2000 (UN Data 2012). The 1982 census showed that basic education was much more widespread than most low-income countries, with 65.5 percent having received formal schooling, and with 34.7 percent above primary level (Naughton 2007, 196). From 1950 to 1973, Chinese real GDP per capita grew by an average of 2.9 percent.
2. Some mainstream growth models incorporate demographic factors (Galor 2011; Hansen and Prescott 2002).
3. The percentages are from Kevin Honglin Zhang and Shunfeng Song (2003) and Central Intelligence Agency (2011). All estimates are problematic because of the large number of (often temporary or unregistered) urban migrants from rural areas.
4. Yasheng Huang (2008) debunks much of the mythology surrounding TVEs and shows that they were typically private rather than collectively owned. From the mid-1990s, TVEs were forced to restructure. Many went bankrupt and some were expropriated by local officials. Rural industries today have taken on new forms and are often tied to local government.
5. In this paper, the classifications of different types of enterprise follow those in official statistics, as there is no available alternative. These classifications have to be treated with great caution, because of numerous complexities of enterprise classification outlined in Huang (2008), including private firms with state shareholdings. But even the official classification is enough to reveal some key dynamic problems.
6. As another explanatory example, the figure does *not* show that the industrial share of "private enterprises" is greater than that of state-owned enterprises. The contribution of private enterprises is the *difference* between the lines above and below the legend "private enterprises" in the figure.
7. Henceforth foreign, Hong Kong, Macao, and Taiwan enterprises are simply referred to as "foreign enterprises."
8. Regrettably, figures are not yet available from after 2007.
9. Peter Nolan and Wang Xiaoqiang (1999, 169) pointed out that SOEs were "not stagnant fossils waiting to die ... this sector has undergone large change due to enhanced enterprise autonomy, the impact of market forces, rapid growth of domestic demand for upstream products, strategic integration with the world economy and the state's policy to promote large businesses."
10. There is evidence that local SOEs, supplying foreign firms in China, benefit from substantial spillover productivity gains (Du, Harrison and Jefferson 2011). But foreign invested firms in China tend to have a relatively low share of domestic value-added content in their exports (Koopman, Wang and Wei 2008).
11. See Melanie Manion (1996), Julia Kwong (1997), Zengke He (2000), Xiaobu Lu (2000) and Peter Nolan (2004, 40-44) on corruption in China, and Geoffrey M. Hodgson and Shuxia Jiang (2007) for a more general discussion.
12. The cross-country evidence of Johan Torstensson (1994), Robert J. Barro (1997), and others, suggests that economic growth is correlated with the rule of law, among additional related factors (Acemoglu and Johnson 2005).
13. As an exception that proves the rule, the China-based private solar panel company Suntech Power has successfully established a global presence. But its founder Shi Zhengrong acquired Australian citizenship before returning to China in 2001 to establish the firm.
14. At least one entrepreneur has been sentenced to death for raising funds outside the state banking system (Branigan 2012).
15. The constitution of the People's Republic of China (2004) states in its Article 11 that, "[t]he State encourages, supports and guides the development of the non-public sectors of the economy and, in accordance with law, exercises supervision and control over the non-public sectors of the economy." Effective compliance with this article depends crucially on the fair and constrained application of the law. Lack of trust in the legal system may raise concerns regarding overly intrusive or inappropriate "supervision and control" of the private sector.
16. See Land Administration Law of the People's Republic of China (2004), articles 2, 4, 10, 12, and 47.

17. On 23 February 2012, the General Office of the State Council announced changes to the *hukou* system. It was declared that access to employment assistance, school education, and occupational training should not be based on *hukou* registrant status. In county-level cities, towns serving as the seat of a county government or other administrative towns, anyone with a legal and stable job and residence may apply for local registered permanent residence with spouse, children, and cohabiting parents. In cities with divided districts (excluding municipalities, sub-provincial-level cities and other large cities), anyone with a legal and stable job and residence, and a full social insurance record, may apply for registered permanent residence with spouse, children, and cohabiting parents (Enorth Netnews 2012).
18. See BBC News (2011), Huang (2011), and other sources from Wikipedia (2011).

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