Institutional Learning and Innovation Are Vital to Keep China’s Economy Growing

By Fu Jun

Much of the global attention focused on the spectacular growth of China’s economy over the past three decades has emphasized the nominal increase in the country’s gross domestic product, which now ranks No. 2 in the world after the United States. Some have argued that growth is the result of state capitalism, rather than markets. But all is not well, as even the Chinese Communist Party recognizes.

For future growth to be sustainable, it will require more institutional learning and innovation. Fu Jun examines the underlying issues at stake in the next stage of China’s growth.

THE TWO TERMS Zhidu (“institution”) and Gaige (“reform”) were the most frequently used in the November 2013 document “Decisions of the 3rd Plenum of the 18th Party Congress of the Chinese Communist Party,” an all-important policy paper by the ruling party that is supposed to serve as the guiding principles for deepening future reforms in China. What is in store, and why is the notion of “institution” important in a country’s economic development? In this brief article, I will begin with a few theoretical remarks on the appropriate role of the state vis-à-vis the market. I will then try to explain what has transpired in China in the past few decades through the prism of institutional reforms from plan to market. I conclude with a few more comments on institutions, efficiency and sustained growth.

SOME THEOREITICAL COMMENTS

For an enlightening theoretical exposition of the appropriate role of the state vis-à-vis the market, a critical interface that relates to all human institutions, I recommend reading or re-reading The Nature of the Firm by Ronald Coase, a Nobel laureate in economics.

To cut a long story short, with respect to the adequacy— or rather, the inadequacy— of the neo-classic economic model, which claims to have proven the efficiency of the market, Coase starts with a puzzle: If the market by itself is 100 percent efficient, why do firms, or hierarchical organizations, exist? His answer is that the market, being horizontal, cannot operate smoothly by itself, since in the real world transaction costs are not free. Firms thus exist to reduce transaction costs by “internalizing market risks,” so to speak. But the question is: Where do we draw the correct line between the firm and the market for rational cost considerations? To Coase’s question, Douglas North, another Nobel Prize winner in economics, provided an answer.

North argues that without hierarchy the market would give rise to higher transaction costs; but hierarchy would also incur administrative costs. Such being the case, the golden point between the two sets of forces— one hierarchical and one horizontal— is where administrative costs equal transaction costs. Eureka: An optimal institutional arrangement between hierarchy and market to achieve an optimal level between private returns and social costs.

North’s answer, nevertheless, is theoretical only. In reality, because measurements can be problematic and economic growth by definition is dynamic, no country can claim to have reached that golden point. But an interesting question is: Which country is closest to the golden point? Here, gross domestic product (GDP) per capita may be a rough indicator. Netting out differentials in natural endowments, low GDP per capita may imply that the hierarchy or the state— relative to the market— is either “too big” or “too small.” Either way, these unsatisfactory equilibriums need to be recalibrated through a process of institutional learning and innovation, such that one gets closer to the golden point.

Theories are important tools that allow us to understand the empirical world. As Albert Einstein would advise, without good theories to organize our observations, phenomena can be misleading. To quote him: “Science is the attempt to make the chaotic diversity of our sense-experience correspond to a logically uniform system of thought.” Armed with the theoretical framework outlined above, let us turn to the story of China.

TAKING STOCK AND LOOKING AHEAD

We begin with two empirical observations. First, despite three decades of reforms and opening up, the role of the state with regard to the market in China is still larger than that in many advanced economies. Second, for almost three decades the Chinese economy has grown at an average annual rate of close to 9 percent. China’s aggregate GDP is now No. 2 in the world, surpassing Japan and second only to the United States. How do we explain China’s dramatic growth story?

If the empirical observations lead you to conclude that China represents a success story of state capitalism, I would offer a note of caution.

Look closely again at China’s institutional infrastructure with a view of the state in relation to the market. In relative terms, China was more of a state-dominated country 30 years ago than it is today. A static picture thus can be misleading; a dynamic picture is more illuminating. Indeed, looked at dynamically, China has been gradually but progressively transforming itself from a very hierarchical institutional arrangement of central planning toward a market-oriented system. Starting almost from scratch prior to reforms, the private sector in China now contributes roughly 60 percent of GDP, 80 percent of exports and over 90 percent of employment— very impressive achievements in a time-span of merely 30 years.

I argue that more than the static picture of state capitalism, it is the dynamic process of institutional learning and innovations by way of market-oriented reforms that fundamentally explains China’s dramatic growth story of the past three decades. China’s economic growth has slowed in recent years, but its growth potential is by no means exhausted. The country is still in the midst of industrialization and urbanization, and it has a lot more to gain in terms of efficiency if it continues the process of institutional learning and innovation from plan to market.

Here, let me add a few statistical brush strokes to give some perspective on China’s growth potential. According to British economist Angus Maddison, 200 years ago China’s population was...
about one-third of the world’s total, and it was producing roughly one-third of total world GDP. China now has about one-fifth of the world’s population; its GDP 30 years ago was below 5 percent of the world’s total, and has now risen to about 10 percent of the world’s total. All else being equal, one-fifth of the world’s population should produce one-fifth of the world’s GDP. Thus, in terms of China’s further growth potential, we are talking about another 10 percent of total world GDP.

Potential, however, is not reality. To realize its potential, China must recalibrate the role of the state with regard to the market. As the above theoretical framework and the dynamic growth story of market-oriented reforms in China indicate, the pendulum must continue to swing more toward the market rather than toward the state. State capitalism is neither the correct explanation for the fundamental cause of the Chinese growth story in the past nor the correct recipe for sustained growth in the future. The fact is that, although China is now No. 2 in the world in terms of aggregate GDP, it continues to lag behind the world average in terms of GDP per capita. GDP per capita is a better measure of efficiency, which reflects a more fundamental source of sustained economic growth, and as such it will become increasingly important for China now that the country is facing growing constraints in both natural and human resources.

MODEL OF EFFICIENCY VS. MODEL OF GROWTH

Rapid growth may be explained by a low starting point, China’s growth story thus far does not represent a model of efficiency, given its current per-capita GDP of roughly $6,000 — within the middle-income range of $1,000-$12,000 as defined by the World Bank, but way below the $40,000 for advanced economies. The country still has a long way to go before emerging from the shadows of the “middle-income trap.” It thus stands to benefit still more from the advanced institutional technologies (as against hardware technologies) of market economies. For one thing, markets and the rule of law (not rule by law) are two sides of the same coin, and thus cannot be separated. For another, sustained economic growth ultimately depends on the market of ideas — the ultimate source of what Austrian economist Joseph Schumpeter calls “the creative destructions” that drive economic development.

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I will elaborate on the relationship between institutions, efficiency and sustained growth. Rapid as it may have been from a low starting point, China’s growth story thus far does not represent a model of efficiency, given its current per-capita GDP of roughly $6,000 — within the middle-income range of $1,000-$12,000 as defined by the World Bank, but way below the $40,000 for advanced economies. The country still has a long way to go before emerging from the shadows of the “middle-income trap.” It thus stands to benefit still more from the advanced institutional technologies (as against hardware technologies) of market economies. For one thing, markets and the rule of law (not rule by law) are two sides of the same coin, and thus cannot be separated. For another, sustained economic growth ultimately depends on the market of ideas — the ultimate source of what Austrian economist Joseph Schumpeter calls “the creative destructions” that drive economic development.

China’s further growth potential, we are talking about another 10 percent of total world GDP. Let me conclude by echoing Coase’s classic question of where to draw the line between the hierarchy and the market in order to achieve an optimal level between private returns and social costs. There are good indications that the new Chinese leadership under President Xi Jinping and Premier Li Keqiang has been pondering the same question. Indeed, in the context of institutional learning and innovations, “The 3rd Plenum Decisions” also emphasized the importance of recalibrating the role of the state vis-à-vis the market and giving the market, not the state, “a decisive role to play” — in the words of the document — in allocating resources and factors of production. Let us hope that in the years to come, these decisions will systematically turn into actions to further realize China’s growth potential.

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