RE-INTERPRETING THE “CHINESE MIRACLE”

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The rapid economic development and transformation of Chinese society over the past three decades has, by a large mass of analysts, been called a “Miracle.” This paper not only addresses the shortcomings of existing interpretations but also develops a new multi-dimensional framework based on North’s theory of institutional change and Hayek’s theory of institutional evolution to explain China’s miraculous growth. Our analysis shows that both Hayekian spontaneous order and Popper’s “piecemeal social engineering” played a major role in attaining China’s miraculous growth.

China is widely regarded as one of the success stories of globalization, emerging into a giant economy of the 21st century. The success that has been identified is in terms of high and sustained rates of aggregate growth and per capita national income, the absence of major financial crisis, and substantial reduction in income poverty. These results in turn are viewed as the consequences of a combination of prudent, yet extensive program of domestic deregulation and global economic integration, as well as a sound macroeconomic management. Hence, it certainly appears that China possesses a “winning recipe” in economic development, which eluded so many countries in the past. A number of analysts have named this the
"Chinese Miracle." However, the existence of a "Chinese Miracle" is surrounded by heated debates and controversies related to the understanding of China’s rapid growth of the past three decades. While some scholars, such as Krugman (1994), Sachs et al. (2000) Shan et al. (2007), are skeptical about the "Chinese Miracle" with reference to scientific and technological innovation, economic efficiency, and political development, others, such as Lin et al. (1994), Cai and Treisman (2006), Herrmann-Pillath (2007), Anderson (2008) and Qin (2008) confirm "Chinese Miracle" in terms of its rapid economic growth in the past 30 years, improvements in the living standards of the world’s largest population, and tremendous changes in many areas of the society. In our view, the answer to the question of whether there is a "Chinese Miracle" depends on the definitions of point makers and general acceptance by the reader. Yet, an undeniable fact is that the Chinese economy has sustained long-term rapid growth for over thirty years, and social scientists have to provide theoretical explanations of the causes of that fact.

The main purpose of this paper is to re-interpret the causes of China’s miraculous growth by the application of theoretical models of institutional change. By fulfilling that purpose, we attempt not only to address the shortcomings in the existing explanations provided in the literature, but also develop an entirely new multi-dimensional framework based on North’s (1990) theory of institutional change and Hayek’s (1973, 1978, 1988) theory of institutional evolution. This new framework, in turn, is applied in an analytic narrative approach to the Chinese reform experience. To pre-view the answer, our analysis points out that both Hayekian spontaneous order and Popper’s “piecemeal social engineering” played a major role in attaining the “Chinese Miracle.” These, in turn, include favorable initial conditions, a relatively proper reform path, favorable informal institutions, pressure for survival, gradual approach to reform, and the existence of multi-action groups.

This paper is organized as follows: Section 1 synthesizes the literature into different perspectives on the causes of the “Chinese Miracle” and
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discusses our research design strategy to develop a new multi-dimensional framework that identifies relevant explanatory variables for the “Chinese Miracle.” In Section 2 we will critically examine a set of explanatory variables identified and selected based on our multi-dimensional framework to provide a comprehensive explanation of the “Chinese Miracle.” Section 3 concludes with a brief discussion of problems and prospects related to China’s reform process.

1. RESEARCH DESIGN: A NEW ANALYTICAL FRAMEWORK TO EXPLAIN THE “CHINESE MIRACLE”

There is an extensive body of literature that attempts to explain the causes of China’s miraculous economic growth. We would like to summarize the plentiful explanations available in the literature, and briefly discuss their advantages and disadvantages.

The first type of explanation is based on a notion of factor determinism. Lin’s (1994) notion of comparative advantage strategy is within the scope of this type, concluding that “Chinese Miracle” is based on China’s comparative advantage, such as cheap labor. From our point of view, however, there are a number of limitations to this explanation. This explanation is only one-dimensional because China’s rapid economic development is a function of many institutional factors, leading the way to a multi-dimensional view. As an illustration, China’s reform began with the introduction of the rural household responsibility system, which basically has no relationship to comparative advantage, but is pertinent to the property rights and governance reform in rural areas. Anderson (2008) argues that China’s high savings rate leads to the “Chinese Miracle.” But this is the same as saying the high-level capital factor is the reason for the high-growth. Without neglecting its importance, it is obvious that a purely high saving rate doesn’t necessarily bring high and sustainable economic growth. If this is possible it depends on whether the savings could be turned into living capital, rather than dead capital (de Soto, 2007). The analysis by Krugman (1994) is of the same type, as it argues that China’s growth relies mainly on inputs.3

The second type of explanation is based on a notion of government determinism. Many forms of reform strategies, including the theory
comparative advantage, tend to misrepresent the reform process and the causes of economic growth: they wrongly presume government determinism of reform or a government-imposed institutional change, and then they attribute the “Chinese Miracle” to government’s performance, or some effective policies of the authoritarian government. Wu (2005) focuses on the causes, background, process, and influence on all structural reforms imposed by the government. His opinion on the role of other forces is unknown. Still, this is not enough as the interpretations are one-sided in that they do not involve non-government forces.

The third type of explanation is based on a notion of initial condition determinism. For example, Qian et al (1993) argue that the structure of Chinese enterprises were of M-form hierarchy (multi-divisional organization structure) before reform, which were different from the U-form hierarchy (unitary system) of the Soviet Union. The specific multi-divisional organization structure of China has thus paved the way for its regional economic development after the reform and opening-up.

The fourth type is based on a notion of intra-party-political competition determinism. For example, Cai (2006) concludes that the “Chinese Miracle” cannot be attributed to political and fiscal decentralization and their subsequent influence, but, on the contrary, the political and fiscal centralization and ultimately, the competition between Beijing’s pro- and anti-market fractions have stimulated growth-emphasizing policies. This explanation, however, is logically inconsistent: If a centralized regime is to implement a growth-enhancing market economic policy, it still needs political, administrative, fiscal and economic decentralization. And just like decentralization could not be considered a reason, as the author argues, the internal fractional conflict of top politicians could not either.

Among interpretations are not only the effects of initial conditions and social and market power, but also the roles of the government; not only the domestic causes but also international causes; not only causes on factors of production and market process, but also causes of institutional arrangements and environments, formal or informal.

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In short, there are, among the interpretations, not only the effects of initial conditions and social and market power, but also the roles of the government; not only the domestic causes but also international causes; not only causes on factors of production, producing process and market process, but also causes on institutional arrangements and environments, formal or informal. Thus, there exists a gap in the existing literature which calls for a more comprehensive analysis.

Overall, the different explanations in previous research have suggested a large number of explanatory variables for explaining the Chinese success. However, most of the scholars focus their research on one of these dimensions, such as initial conditions, institutional changes, state and market, etc., and each of these explanations fits the observed facts to some extent but not one of them provides an adequate explanation. It seems unlikely that any single-level variable affords an adequate understanding of the complexity of the causes of the Chinese success, because a joint effect of multiple causal forces shapes the complexity and determines the outcome. A more comprehensive scheme is thus needed to provide a multidimensional approach to the problem under investigation. A synthesis created by integrating the key elements of each of the explanations can develop a more comprehensive scheme against which the key causal variables can be located, and thus a more comprehensive explanation can be provided for understanding the Chinese success, because, in a more comprehensive scheme, more is examined and less is assumed.

A synthesis is not only optimal but also achievable. Those explanations do not necessarily compete with each other, given that each of them fits the observed phenomenon to a greater or lesser extent, and that many of the insights and conclusions from different theoretical approaches reflect different sides of an empirical world and are thus part of a unified whole picture of the “Chinese Miracle”. Some of the causal factors are structural, some not, some institutional, some political-economic, and others might be mixed. Therefore, different approaches should be considered complementary in explaining the observed phenomena. A combination of the key elements of different approaches into a multi-dimensional analytical framework should be most optimal in explaining the causes of the Chinese success.

Apart from neoclassical economics and regional economics, we should also take into account other theoretical perspectives such as political
economy and institutional evolution. The political economy involves new institutional economics, the Austrian School of Economics (Hayek, 1973, 1988, 1998; Papke ed., 2001), constitutional economics (Buchanan and Tullock, 1965; Brennan and Buchanan, 1980/1985) and Freiburg School (Eucken, 2001). The new institutional economics involves here mainly North’s theory of institutional change, while the theory of institutional evolution mainly refers to Hayek’s thought on institutional evolution. We will integrate and modify North’s institutional change theory and Hayek’s thought on institutional evolution. On this ground we develop our new multi-dimensional framework of institutional change. Also our framework integrates, as an inclusive and encompassing approach, all the existing major approaches to the interpretation of the “Chinese Miracle.”

What is needed is to find out a way of integrating various variables into a general analytical framework in which the key elements of different approaches can fit together in a logic of explanation. This new multi-dimensional framework is based on the synthesis of North’s theory of institutional change and Hayek’s theory of institutional evolution, by which the key elements of different approaches can fit together and key variables can be selected in a logical explanation for China’s miraculous growth. In the following pages of this section, we will examine and synthesize some key elements of North’s theory and Hayek’s theory in such a way as to develop a new multi-dimensional framework.

Since the “Chinese Miracle” is related to its structural reform, in studying what led to the “Miracle,” the political economy aspect is inevitably involved. North’s theory of institutional change (North 1990) is mostly involved within the spectrum of new institutional economics. According to North, institutional innovation or change would fuel the increase in productivity and economic growth in the absence of technological change (North 1968; Chen 1994). From this perspective, institutional change and technological change are both essential for economic growth.

Institutions are the rules of the game of a society or more formally are the humanly devised constraints on the structure of human interaction.
North claims that institutions are composed of formal rules and informal constraints (or informal institutions), and the enforcement characteristic of both. The informal constraints consist of sanctions, taboos, customs, traditions, and codes of conduct. Formal rules include constitutions, laws, property rights, etc. Also institutions could be divided into institutional environment and institutional arrangements. By institutional environment we mean a series of political, social, and legal rules on which the basis of production, exchange and allocation is constructed; the institutional arrangements, formal or informal, are rules to adjust specific behaviors or relationships (North and Davis, 1994). The institutional change encompasses the creation and alternation of institutions and the way they are broken through along with time. In this process, the initial conditions become vital. Yet there are problems of path dependence or “lock-ins” standing in the way. According to North, an institutional change consists of five steps: first, to form a primary action group who promotes institutional change; second, to propose the blueprints for alternation of rules; third, to assess and choose from the proposals in conformity with some principles for institutional change; fourth, to form a secondary action group, say, the subordinate group that promotes institutional change; the last, the two groups try together to realize the institutional change (Davis et al, 1971; Chen, 1994).

However, the core of North’s works is still the equilibrium theory of neoclassical economics. It only puts emphasis on institutional construction and does not include the effects of institutional evolution. The dichotomy of primary action group and secondary action group is applicable for illustrating stylized comparative static analysis, but not universally useful, especially when it comes to the evolution of formal and informal institutions.

We now turn to a framework of institutional evolution as a modification and supplement for North’s framework of institutional change. Hayek’s theory of institutional evolution advocates the notion of spontaneous order and embraces perspectives of the systems theory and evolution theory.
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According to Hayek, spontaneous order is endogenous, the product of human action but not human design (Hayek, 1973). Specifically, this order is a self-generating outcome of the internal organization rather than a product of a deliberate plan, design or construction by some external individuals. For example, the market order or most of the rules of customs come into being via evolution instead of deliberate arrangement or planning, thus they are spontaneous orders. The constructed order is the opposite of spontaneous order. The former describes an imposed and planned order (Hayek, 1973, Papke ed., 2001), and is always a kind of detailed and deliberately designed order to serve the purposes of the designer. In contrast, a spontaneous order doesn’t serve any specific purpose, need not manifest itself to our senses but may be based on purely abstract relations which we can only mentally reconstruct (Hayek, 1973).

The evolutionary rationalism advocated by Hayek is closely linked with Popper’s critical rationalism. In accordance with Popper, only through trials and errors, conjectures and refutations can we gradually approximate the truth (Popper, 1972; Hayek, 1988; Engel, 2001). Accordingly, Hayek agrees with Popper’s piecemeal social engineering which allows for trials and errors (Popper 1945/1992), thus favoring the thought of piecemeal construction rather than total construction (Hayek, 1978).

Now, within Hayek’s thoughts we dissect the dichotomy of constructivist rationalism and evolutionary rationalism, from which we abstract three kinds of institutional change: first, total construction-based institutional change (holistic constructivism); second, the spontaneous change of institutions; and third, piecemeal construction-based institutional change. Correspondingly, the dichotomy of spontaneous order and constructed order is substituted by a trichotomy of spontaneous order, total construction order and interim order as a result of the prominent interim order form, which would in fact be called a piecemeal construction order which encompasses many interim forms between the two poles of spontaneous order and total construction order (see Table 1 in Appendix).
Under this framework, rules or institutions can be conceived as a mixed trichotomy including the external rules or institutions (Kasper et al. 1998) corresponding to “thesis”, internal rules or institutions (ibid.) corresponding to “nomos” and mixed rules, rather than the Hayekian dichotomy of the “thesis” and “nomos.” By “thesis” is meant the organizational rules that are deliberately designed according to the will of the organizers or rulers, and serve the special purpose of those special people—they are particular rules rather than general ones (Hayek, 1973). In contrast, by “nomos” we mean rules of just conduct or general conduct that come into being spontaneously during the long-term cultural evolutions in society; or “law” in the strict form by Hayek. The “law” is not a deliberate human design but the result of human action and it includes law of freedom (the common law), tradition, custom and convention.

It is thus clear that our analytical framework enters the dynamic evolutionary theory of institutional change, within which North’s concepts of initial state, path dependence, lock-in, action groups are also applicable. This framework follows a conduct–structure–performance approach rather than a structure–conduct–performance approach of neoclassical economics.

We can abstract two criteria from Hayek’s theory of order to evaluate the rules and orders: first is the compatibility of the institutional change with the freedom of individuals; second is whether we could make sufficient use of Hayek’s division of knowledge (Hayek, 1973). Hayek doesn’t mention explicitly these two criteria. Both of them are hidden, but traceable throughout his works. From the viewpoint of economic growth, giving consideration to the two criteria is an indispensable condition for the liberation and release of productive forces and a guarantee for the direction of evolution of the rules and orders in the sense of their improvement. From the constitutional point of view (Buchanan et al., 1965; Brennan et al., 1980, 1985), that is the perspective of rule making, these two criteria are of importance. At last, they can be used to make evaluations of institutional change.
Spontaneous and piecemeal construction-based institutional change is an evolutionary and trial and error process. This is indeed the reform and opening process in post-Mao China in the past thirty years. China’s former planned economy under Mao serves as a good example of the total construction-based institutional change. A planned economy cannot make use of the division of knowledge, and it replaces the different preferences of different individuals with the single preference of the planner in the allocation of resources. It does not provide individuals with freedoms and incentives in pursuit of profit and innovation, denies the aspirations of human nature, and thus results in low productivity and poor efficiency.

2. RE-INTERPRETING THE CAUSES OF THE “CHINESE MIRACLE”

This section explains the “Chinese Miracle” by focusing on the underlying institutional change and evolution based on the new multi-dimensional framework, from which the most important components are derived and synthesized: (i) structural forces, (ii) institutional factors, (iii) political economy, (iv) people’s choice and, (v) elite choice. Given the Chinese context, these key components are made up of a set of favorable initial conditions, a relatively proper reform path, favorable informal institutions, pressure for survival, gradual approach to reform, and the existence of multi action groups. Working in combination, these critical components merge into one main feature underlying China’s rapid economic growth and, hence the so-called “Chinese Miracle”—the liberation of productive forces, i.e., productive forces are liberated from the state planners and designers (see Figure 1 in Appendix).

2.1 Favorable Initial Conditions

A developing economy’s policy space and its performance over time are constrained by the initial conditions bestowed upon it by nature and an economy’s past (Ranis, 1995). In China, favorable initial conditions include decentralized, multi-centered spatial economic structure, M-form organizational structure, low level of labor cost and regulation, and a favorable macro political and economic environment.
Decentralized, multi-centered spatial economic structure: In the era of planning economy, the central government delivered heavy-industry input to the underdeveloped third-tier regions out of the fear of war, and encouraged self-sufficiency for each province; that is, much of the planning and management authority for economy and investment was delegated to provincial governments (Chen 2003). In practice, the central planner had created a decentralized, multi-centered spatial economic structure as an unintended consequence of planning, which in turn created conditions for the regions to make use of their own talents and resource to compete with each other and develop after reform and opening-up began in 1978.

Multi-divisional organization: As mentioned above, the enterprises in China prior to reform were of the M-form organizational structure. In contrast, the Soviet Union enterprises were mostly of the U-form (Qian et al., 1993). The structural form of Chinese enterprises provided particularly convenient means for the central government to delegate part of the management authority of the state-owned enterprises to local governments in order for them to boost their motivation for management and development.

Low level of labor cost and regulation: Cheap labor is partly the result of China’s catch-up strategy, where consumption was suppressed and investment was encouraged; light industries were suppressed and heavy industries were encouraged; income for workers and farmers was dampened and much of the surplus of the industrial and agricultural production was transferred to heavy industries for the benefit of China’s overall industrialization. There was ample labor supply in China but the capital supply was relatively scarce and that paved the way for China to participate in the international division of labor or the foreign capital to have a position in China’s division of labor. That a large pool of labor has brought about abundant cheap goods and injections of foreign capital, along with advanced management skills and knowhow, has provided the basis for enhancing product quality. There was little regulation of the labor market. That is to say, to some extent, China is one of the world’s most flexible countries that put the least regulations on labor market.

Favorable macro political and economic environment: Since the end of the Cultural Revolution, stability has been a consensus of the political elite as well as the general population despite disagreements on the path of reform or the kind of reform. A favorable macro political and economic
environment has been created and maintained for over three decades in the name of stability and reform. The “Chinese Miracle” would be unthinkable without such a favorable environment, which is considered essential for foreign direct investment and business operation in China.

2.2 Relatively Proper Path of Reform

China’s path of reform is basically one characterized by gradual reform and opening-up. In particular, it includes the adoption of the least resistance path at the beginning of reform, the selective stabilization of currency value, gradual introduction of private property rights and competition, the adoption of open market, gradual approach to freedom of contract and the strengthening of personal and corporate liability, and ensuring the consistency and continuity of economic policy. Although this kind of step-by-step, selectively opening-up approach has been successful, it cannot be considered the key point of the “Chinese Miracle.” Rather, it should be pointed out that it liberated the productive forces to some extent. According to general economic theory, it improves the efficiency of resource allocation and expands the production frontier, but still limits further enhancement for resource allocation and thus further expansion of the production frontier.

Adoption of path with least resistance at the beginning of reform: Choosing the way of least resistance is in accordance with North’s theory of institutional change that the expected gain should exceed the expected cost. The rural household responsibility system was initially non-governmental and opposite to national government policy. It was a spontaneous order in the beginning. Rules were mainly what Hayek means by “nomos”, with deliberated design of some further rules among the peasants. They were afterwards recognized, modified and extended by the government as formal rules.

Fiscal decentralization: Fiscal contracts were introduced in the early 1980s between the central government and local governments across China, which increased the incentive for local governments to participate in and enhance local economic development. The original design for fiscal decentralization was in line with the Pareto improvement concept in relation to revenues of central government and local governments. However, the strategic actions of the local governments eroded the central government’s
share of revenue in forms of the so called “hiding the wealth among people” and the extra-budgetary and extra-revenue system.

**The dual-track price system:** Local state-owned and collective enterprises, even township and village (collective) enterprises (TVEs) were allowed to be established. At the very beginning, the resources were in the control of state-owned enterprises. Later on, via the dual-track price system which lasted in general until the early 1990s, some resource would be allocated to the market entities as represented by TVEs outside the state-owned enterprises (SOEs) through exchange at higher prices. This was undoubtedly the consequence of the Pareto improvement concept. Also, in the very beginning, the dual-track price system emerged as a spontaneous order of transactions between the SOEs and TVEs, induced by the profit opportunities in market factors (raw materials and resources) and goods. The central government attempted to tackle the transactions and in the end recognized the transactions and thus the dual-track system (Zhang 2002).

**Selective stabilization of the currency value:** The overall rate of inflation in China was relatively high before 1994. However, China chose to selectively stabilize its currency value by allowing foreign invested enterprises, including Sino-foreign joint ventures and cooperative businesses, and wholly foreign-owned enterprises in China to possess foreign exchange certificates which were convertible to foreign currencies. At the beginning of 1994, the new People’s Bank Law and new Budget Law eliminated channels for the Ministry of Finance to borrow money or take overdraft from the central bank in order to control price increases. Fiscal surveillance thus matters in controlling price increases. We can see the importance of it in preserving the stability of the currency value. Additionally, capital accounts have been opened restrictedly and selectively over time.9

**Gradual re-emergence and introduction of private property rights:** Private property rights are of great importance (Locke 1690; de Soto 2007). The re-emergence of private property rights in China has evolved slowly. In agricultural production, the household responsibility system did not give the farmers private land ownership, but land-use rights.
re-emergence of private property rights in China has evolved slowly. In agricultural production, the household responsibility system did not give the farmers private land ownership, but land-use rights. At the early stage of reform, the state-owned enterprises were the main account. But with administrative and fiscal decentralization, collective-owned economy in rural and urban area, especially township and village (collective) enterprises (TVEs), gained momentum and struggled to compete with the state-owned property rights. Compared with the state-owned economy, collective ownership had advantages over state ownership in that, for instance, personal liability was more visible. From the mid-1980s, the TVEs developed in large scale, and by end of the 1990s, TVEs accounted for half of the country’s industrial output; yet local government officials or village cadres took charge of the TVEs and had similar soft budget constraint (Kornai, 1986) as the state-owned enterprises.

The individual industrial and commercial households and private enterprises in China started spontaneously. As a next step, entities with up to 7 employees were accepted by government as individual industrial and commercial households. However, the development of such private economy is seen as an evolutionary process that would never stop at this limited scale if productive forces were unleashed. The entrepreneurs for the non-state owned enterprises were suppressed at an early stage, and were then gradually recognized by the government. In the early 1980s, the rural cottage industries mushroomed, the rural and urban markets enlarged day by day and a large number of specialized households and key households with a certain production scale emerged. Not until 1998 did constitutional amendments give legal status to private enterprises and in the same year the State Council promulgated Provisional Regulations of the People’s Republic of China on Private Enterprises. In 1992, the Third Plenary Session of its Fourteenth Central Committee of the Chinese Communist Party put forward that economies under various ownership systems would be in a long-term coexistence with public ownership and they would develop together. From then on, China rapidly developed its private sector.
The actual economic development shows that there was an efficiency gap between enterprises with different ownership, with private ownership outperforming others (Liu 2000 and 2004), which then led to two waves of privatization. The first wave took place more or less in the period of 1992–1995, where the reform of state-owned enterprises was characterized by “transforming the operational mechanisms” while the collective enterprises were more of a transition type, involving full or partial privatization. The second wave happened after 1996, when the state-owned enterprises’ reform was characterized by establishing a modern enterprises system as well as “managing well large enterprises and adopting a flexible policy towards small ones,” and many collective enterprises experienced privatization.

Gradual introduction of market competition: “Chinese Miracle” is also related to the introduction of market competition. First is international competition. Globalization has brought in international competition, foreign capital, foreign management experience and technology. Especially Hong Kong and Taiwan have played an important role in this process. Second is the competition between different domestic enterprises, including that between different ownerships and different enterprises.

The unintended introduction of local government competition: At the early stage of reform—after administrative and fiscal decentralization—local governments gained so called “regional property rights” (Granick 1990; Herrmann-Pillath 1999), which greatly stimulated the incentive to develop the local economy. Local governments began competing for resources and market. This local government competition was introduced as an unintended consequence of the decentralization, yet it has been beneficial to economic development. This kind of decentralization is what Weingast and Qian (1995) define as “market preserving federalism.”

The competition among local governments and between local governments and central government sometimes intertwined (Herrmann-Pillath, 1999), providing a vivid picture of the nature of the central government and local governments as “competitive governments” in the Bretonnian sense (Breton, 1998; Herrmann-Pillath, 1999/2006). For example, the local governments would add benefits for foreign investments beyond the tax benefits central government had agreed to in order to attract foreign investments. Or the local governments would increase subsidies for foreign investments in violation of the central government’s uniform requirements.
Additionally, competition among local governments resulted in the privatization of local business (Zhang, 1998). However, the competition also had some negative, unintended results. There were many complaints that, in their efforts to outbid each other in getting foreign investment, local governments were giving too many concessions to foreign investors. There was too much redundancy in what the local governments constructed, and not enough attention to what was needed.

**Selective and gradual opening of the market:** Ever since the reform process began in 1978, China has opened its foreign capital and domestic capital market selectively and gradually and made use of the international market, including selectively opening some regions, first special administrative region and then coastal regions. Selective opening of the market has promoted the competition between enterprises of different ownerships, and helped improve the efficiency of the economy as a whole. Additionally, export-orientation facilitated the use of China’s comparative advantage in the international division of labor.

**Gradual enhancement of freedom of contract:** In the planned economy period, there was no freedom of contract; the unified deployment of resources by the government would not solve the problem of innovation and the inability to efficiently aggregate and utilize a large amount of dispersed knowledge within the economy. Economic reform and opening-up has made social forces and market actors organize production and exchange in a better way in order to achieve division of labor and knowledge (Hayek, 1973) via voluntary contracting, which would create more wealth. Only the introduction of private property rights would make a great number of complex contracts possible.

**Strengthening individual and corporate liability:** The privatization, marketization and emergence of the private sector is the process of enhancing private property rights. The latter means also a process of strengthening...
individual and corporate liability. The gradual introduction of property rights and freedom of contract has also laid a foundation for strengthening and enforcing individual and corporate liability, which can provide positive impetus to economic growth.

Consistency and continuity of domestic and foreign economic policy: Since the beginning of reform the government authorities have provided a relatively stable policy environment for foreign investment. For example, the commitment on tax concession to foreign investments: income tax was free for the first three years and half for the next five years. For domestic private enterprises, the economic policy and regulations are relatively stable and consistent. However, for small enterprises of special industry, for example, the “five small” enterprises (which are hazardous to the environment), or the enterprises conducting so-called “repetitive construction” (in fact “repetitive production”), the government has enacted a force-out policy.

The above reform approaches, no matter if they were of the nature of spontaneous order or piecemeal social engineering, rendered in general a higher degree of economic freedom and allowed market actors a larger free space of division of knowledge. In addition, there were also some attempts which reflected a total construction approach but which proved unsuccessful. Also the success of the rural household responsibility system brought about supportive “momentum effects” upon further reforms, for instance the dual-track system and fiscal decentralization, which brought about effects for the next steps of reforms.

Furthermore, many reform approaches as mentioned above appear to be government-led, but in practice are due to factors both inside and outside of government control. At least until mid-2003, the government had mainly chosen to quit from the economic sector to a certain extent, especially the competitive sector; removed a large number of restrictions, provided a policy and regulations environment that was beneficial for the
development of industries and commerce and created and sustained, in most part of the competitive sector, a relatively well functioning but still “ailing” competition order which has been favorable to performance competition and economic growth. The competition order has provided a large space for bringing into play entrepreneurship in large scale.

2.3 Advantageous Informal Institutions and the Pressure for Survival

There are informal institutions that are advantageous as well as informal institutional that are disadvantageous to the development of the Chinese economy. The informal institutions and pressure for survival that had been working from before the Chinese revolution are beneficial for economic growth in China.

*Tradition:* Tradition in the Chinese culture, as an informal institution within Chinese society, is beneficial for industrial and commercial development. Confucianism is not in favor of politicians and government officials doing business, but does not prevent ordinary people from doing so.\(^{12}\) The two are reflected in the “great and little tradition,” which is inherited from Chinese history. Mencius was even a proponent of an order of exchange, or “catallaxy” in the Hayekian sense (Hayek 1973), to create the benefits of two sides through exchange. The official ethics and culture involved in the great tradition are mostly ethic requirements, while the ethics and culture within the little tradition are truly internalized, practical informal institutions and rules. Government officials formally stressed agricultural production and restraining commerce, but had to attach importance to and make use of commerce in reality in ancient China.\(^ {13}\)

*The pursuit of a better life:* Chinese people have always been in pursuit of a better life. This ideology is a kind of informal institution in itself and would help bring into play Chinese entrepreneurship. On the one hand, the Chinese people who believe in Buddhism, as well as many Christians and are in pursuit of the realization in heaven. On the other hand, the Chinese people are pragmatic, seeking mundane satisfaction and better secular life on earth. This attitude among Chinese people, expressed as a kind of commercial culture, was suppressed under the planning era, but has been acting as a motivation for wealth creation after the reform was initiated.
The tradition and attitude of being flexible, hard working, and entrepreneurial: The pressure of survival in history and the pursuit of a better life have made the Chinese people relatively flexible, hard-working, and entrepreneurial. The severe living environments in history and survival pressure have affected people’s behavior and helped to shape their hard-working characteristic and pragmatic attitude, which proved beneficial for local economic growth after the reform. Herrmann-Pillath (2007) even argues that the high degree of flexibility and entrepreneurial alertness is the main explanation of the “Chinese Miracle.”

Traditional emphasis on education: The Chinese people have a tradition of attaching great importance to children’s education. This tradition has formed a relatively well-trained labor force and entrepreneurs in China, with much attention to learning by doing. Culture, tradition of education and the pursuit of a better life have created an informal institutional basis for the emergency of a large number of private entrepreneurs and their bringing into play the entrepreneurship in China after 1978. The pressure of survival and the extension of government’s permission (initially tolerance, acquiescence, non-rejection, or even government officials’ own involvement) have further promoted the exertion of entrepreneurship. It should be further noted that even the motivation for government officials’ reform, and the large scale investment from entrepreneurs in Hong Kong and Taiwan, has been influenced by the Chinese culture and pro-education tradition, as well as the pursuit of a better life.

However, there is also an ideological obstacle for economic growth—the factor of the official orthodox ideology, which is also a part of informal institutions. This factor attributes to the political lock-in and path dependence in the entire reform process in China. Nevertheless, the realization of the “Chinese Miracle” is the process of overcoming orthodox official ideology that hampers as “thick institutional issue” (Hassink, 2004) the economic growth, and the process of disenchantment of the orthodox official ideology. Here, the survival pressure and the pursuit of a better life that are conducive for economic growth are the key irreversible factors for reform.
for reform. That is because, along with the reform, officials as well as the people have seen more overall benefits, and the reversal of reform means giving up these benefits.

2.4 The Gradualist Approach of Reform

China is often cited as the leading example of a successful gradualist approach to transition from the planned command economy. Chinese reform has demonstrated a different pattern that was characterized by gradual, experimental, phased and partial reform as compared to the former communist countries in Russia and Eastern Europe that were illustrative of a “neoclassical” big bang or radical approach (Guo, 2006). It is a transition without design (Herrmann-Pillath, 2006), and the famous slogan is “crossing the river by feeling the stones.” China has experienced a lengthy process of readjusting reform objectives from “a planned economy with some market adjustment,” to “a combination of plan and market,” and then to “a socialist market economy” (Fan, 1994).

The choice of gradual reform is much related to the large resistance or lack of consensus among decision makers.

Gradual reform is beneficial for the stability of politics, economy, and social order, as well as the stability of regime. According to the Freiburg School (Eucken, 1952), there are many sub-orders within economic order and social order, and these sub-orders are interdependent with each other in a functioning economic and social order. There is no doubt that this kind of interdependence is the basis for the operation of the whole order. Shock therapy breaks the interdependence between the sub-orders overnight, and since it is hard to run the new sub-orders and establish their interdependence in a short period, the new order as a whole cannot be established and operate in a stable way in short time and the whole economy would be in severe imbalance. There is no such problem with gradualism, which is in line with the natural rules of development. Additionally, gradual approach allows for the development and evolution of the informal institutions such as culture and ideology. Shock therapy tries to change and adjust informal institutions overnight, which would
inevitably experience frustration since informal institutions in general are hard to change or shape in a short period.

The flaw of gradualist reform is that it may be used by the vested interests to impede the process of reform and the stronger the vested interests, or the more of them, the more resistance. And the gradual reform itself could be used as an instrument for corruption since gradualism generally means marginal breakthroughs in changing some existing rules or policies. That kind of breakthrough often involves rent. Also, some interest groups could provide benefits to the government officials in exchange for getting more rent (see Tullock, 1967; Krueger, 1974).

Moreover, the choice of gradualist reform is related to resistance or lack of consensus among decision makers. Most top-down reforms had the pattern of “first experiment and then extend it,” and they had no association with the government intention to try and improve, but to preserve the stability of political regime and to seek their own department interests. Bottom-up reforms often adopt a “first do it and then to be recognized” approach. The reforms often occur spontaneously in an illegal state: they happen first locally and spontaneously, and after becoming a performance benchmark and having constituted a reversed pressure transmission mechanism, the legitimacy of them are eventually recognized, thus providing a basis for their further enforcement. The introduction of rural household responsibility system, dual-track system, and private property rights are of that type. Many top-down reforms are also of the “first do and then recognize” approach. Often the experimental units are first permitted, at the boundary of legal and illegal, regular and non-regular actions, and then the achievements are recognized (or denied) and furthered by the government. Such reforms include the reform of state-owned enterprises and township collective enterprises.

2.5 Multi-Action Groups to Promote Reform and Development

Since the reform of the whole economic system involves the reforms of several sub-systems or suborders, there is more than one source for pushing forward the reform. Views considering reform process to be purely top-down or bottom-up are both biased. Both people’s choice and elite choice played roles in the overall reform process. And, the action group
of pushing forward reform and that of pushing forward economic growth should be differentiated.

In the case of rural household responsibility system reform, mainly the survival pressure resulted in farmers in Fengyang county, Anhui province, taking risk and spontaneously organizing and implementing the “fixing of farm output quotas for each household.” Along with the learning and imitation, the “fixing of farm output quotas for each household” was rapidly spread in Fengyang county. This reflected a spontaneous order. As a kind of internal order, it was the result of actions of those actors within the system, rather than from the plan, design or construction of outside people. And the operation of it relied on the “nomos” in a Hayekian sense. After the reform and opening-up, the household responsibility system has been formalized and extended with the recognition of government and, hence become an external piecemeal construction-based order. From the perspective of the pattern but also from the perspective of the two stages: formation of spontaneous order before the extension and the government recognition after the event, is in line with North’s differentiation on the primary action group (peasants who spontaneously implementing contract) and the secondary action group (the government). But considering the development process of the spontaneous order before the extension, even if there were one or several initiators for “fixing of farm output quotas for each household,” the shaping of the whole spontaneous order was the result of institutional learning, imitating, and innovation, and it is hard to distinguish clearly between the primary action group and secondary action group. In fact, all these action groups had their own aims and each did things in their own ways. This was entirely different to the institutional change with specific aim described in the framework of North’s institutional change.

The establishment of some other reform measures was similar to that of the rural household responsibility system, but they had different approaches. Without the recognition by the state, the action group has taken entrepreneur-like measures spontaneously, and from these measures a kind of spontaneous order has evolved, which was then, sometimes after tackling or tolerating, recognized, formalized and extended to one external piecemeal construction-based order (that was given a formal legal position and legal form by the government). This piecemeal construction-based order has taken in the elements of spontaneous evolution, and its formal
order is inclined to wander between a piecemeal construction-based order and a spontaneous order. For example, after the reform and opening-up, the development of private enterprises in China was a spontaneous process. As long as the private economy was gradually recognized by the government, the private sector formalized and extended it into a type of piecemeal construction-based order. It should be noted that this piecemeal construction-based order has accommodated elements of spontaneous evolution. Along with the further expansion of the market and private sector, the whole private sector will show more of a spontaneous order.

No doubt, the government has played an important role as an action group as most reform measures were introduced by the government. Examples of such reforms are fiscal and administrative decentralization, selectively preserving a stable currency, gradual introduction of private property rights and competition, selectively opening the market, gradual introduction of freedom of contract, strengthening responsibility and preserving the consistency and continuity of foreign economic policies, and the government’s xiahai ("go down to the sea") policy that actually encouraged individuals to quit their governmental jobs to start their own business or work in business sectors. These were all piecemeal constructivism orders. The whole process took the form of a “crab-walk path”—one step forward and half a step backwards. When the government opened the market, introduced competition, exited from the competitive sector to some degree, it was the private actors within the economy that gained the broad space for free development and promoted economic growth finally leading to the “Chinese Miracle.”

3. CONCLUSION: PROBLEMS AND PROSPECTS OF REFORM

The rapid economic development and transformation of the Chinese society over the past three decades has been called a “Miracle.” The existing explanations are not sufficient to explain China’s rapid growth in a comprehensive manner. We re-interpret the causes of China’s miraculous growth by developing a new multi-dimensional framework based on North’s (1990) theory of institutional change and Hayek’s (1973, 1978, 1988) theory of institutional evolution. By applying this framework to the Chinese
experience, we argue that multidimensional variables derived from theories of Hayekian spontaneous order and Popper’s “piecemeal social engineering” have played a major role in attaining the “Chinese Miracle”. These include favorable initial conditions, a relatively proper reform path, favorable informal institutions, pressure for survival, gradual approach to reform, and the existence of multi-action groups.

It is important for China to continue to adopt and improve the set of institutions that have proved successful for maintaining rapid and sustained economic growth and overall development. There are, however, several problems in the Chinese reform process, including lack of labor protection and social securities, severe pollution, violation by arbitrarily taking of farmers’ land rights, severe corruption, regional income disparities, potential risk of macro-economic instability and financial crisis (as a result of over-borrowing and mis-allocation of financial resources), etc. Chinese reform faces a greater difficulty in dealing with core institutional problems, such as preserving the land rights of farmers, breaking up the state monopoly by SOE, (including the state-owned commercial banks), developing competitive market orders, and preventing the government from intervening in the micro-economic processes. In order to solve these problems, constitutional reforms which Sachs et al (2000) and later Zhiwu Chen (Li 2008) suggested should be necessary, since limiting government power and safeguarding individual rights would be involved in political reforms.

There has been a reemergence of economic thought and the policy of populism, statism, nationalism, as well as dirigisme in the past several years. The economic freedom of individuals and enterprises, as the basis of “Chinese Miracle,” are being eroded. Entrepreneurs’ property rights are being deprived more and more quickly (for example, through large number of labor laws and regulations), economic principles and fiscal and monetary disciplines are being abolished gradually. For instance, the National Development and Reform Commission of the State Council decides, in
collaboration with the Central Bank and the China Banking Regulatory Commission, credit policies which should originally be decided by the banks independently. Moreover, the government sets industrial policies as policy priorities, rather than competition policy. A large amount of transfer payments and subsidies have enhanced individual and local dependence on the central state and many people are losing their autonomy and independence. The above-mentioned formal rules or institutions being eroded is not the worst thing. The worst thing is that public awareness of the importance of rule-orientation is losing ground. And after losing these informal institutions, it may take several decades to reshape them, if at all possible.

If property right protection is not provided, a favorable investment environment and a competitive market order that would enhance performance competition and achieve high efficiency would be lost, the cost for enterprises should inevitably increase, and the technical innovation and industrial upgrading would lag behind. Besides that, many other costs would also increase, such as the increase of disadvantageous supply factors domestic and abroad. If that happens, the “Chinese Miracle” would end much earlier than expected.
### Appendix

#### Table 1: Our Trichotomy vs Hayekian Dichotomy: Types of Institutional Change, Orders and Rules

<table>
<thead>
<tr>
<th>Type of institutional change</th>
<th>Hayekian ideal-typical dichotomy</th>
<th>Authors’ trichotomy</th>
<th>Note</th>
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<tr>
<td>Total construction</td>
<td>Total construction of institutions</td>
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<tr>
<td>Piecemeal institutional construction</td>
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<td>Hayek also accepts “piecemeal social engineering” in Popper’s sense</td>
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<tr>
<td>Spontaneous order</td>
<td>Spontaneous change of institutions</td>
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<tr>
<td>Types of orders</td>
<td>Constructed order</td>
<td>Total construction order</td>
<td>Hayek refers “constructed order” to “total construction”</td>
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<tr>
<td>Interim order</td>
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<tr>
<td>Spontaneous order</td>
<td>Spontaneous order</td>
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<tr>
<td>Types of rules</td>
<td>Thesis</td>
<td>External rules</td>
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<td></td>
<td>Nomos</td>
<td>Internal rules</td>
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<td>Mixed rules</td>
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</tbody>
</table>
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Figure 1. Multi-Dimensional Approach

- **Formal institutions**: - Introduction of rural household responsibility system - Fiscal decentralization - Introduction of dual-track price system - Introduction of private property rights - Gradual development of market competition - Selective and gradual opening of the market - Gradual enhancement of freedom of contract - Consistency and continuity of domestic and foreign economic policy
- **Informal institutions**: - Disenchantment of orthodox doctrine - Little tradition - Pursuit of a better life - Tradition and attitude of being flexible, hard working and entrepreneurial - Traditional emphasis on education
- **Initial conditions**: - Decentralized, multi-centered spatial economic structure - Multi-divisional organization of enterprise - Low level labor cost and regulation - Favorable macro-political and economic environment
- **Pressure for survival**
- **Spontaneous orders**: - Emergence of rural household responsibility system - Emergence of double-track system - Re-emergence of private property rights
- **Strong leadership’s commitment to reform** (Deng Xiaoping)
- **Government’s recognition, modification and extension of spontaneously emerged orders**

**Structural Factors**

**Institutional Factors**

**Political Economy**

**People’s Choice**

**Elite Choice**

Liberation of Productive Forces

“Chinese Miracle”
Notes

1. From an economic history perspective, a miracle should fulfill four basic conditions: First, the economy should have experienced high growth; second, the high growth should have been sustained over an extended period; third, the economic growth should be stable; fourth, technological development (including the improvement of technological efficiency) should somewhat or largely contribute to the economic growth.

2. For analytic narratives, see Bates et al., (1998).

3. However, some developments, to some degree, support the idea that Chinese economic growth not only relies on inputs, but also on technology and development. In the early stage of reform, i.e., 1979-1992, the growth rate of Total Factor Productivity (TFP) experienced an average annual 1.7 percent rate of growth. This rise in TFP was followed by declining TFP for five consecutive years and did not recover until year 2000. In the entire reform period, the contribution of TFP change to economic growth was 12.7%. Purely in terms of the science and technology development in the period from 1991 to 2007, the number of authorized patent applications increased from 24,600 in 1991 to 351,800 pieces in 2007 (Zheng, 2008).

4. See Lin et al. (1994) on imposed institutional change or the corresponding induced institutional change.


7. Deng, (2000). According to Blackstone (1765-1769), common law is composed of convention and basic rules whose efficiency is constructed by the judges of the common law courts.

8. This does not affect the nature of the order as a spontaneous one. Vanberg (1994:197) notes that “deliberate intervention in the framework of rules and institutions cannot, per se, be censured to be in irreconcilable conflict with the fundamental principles of a spontaneous order.” His notion is based on Hayek’s following statement: “While the rules, on which a spontaneous order rests, may also be of spontaneous origin, this need not always be the case…and it is at least conceivable that the formation of a spontaneous order relies entirely on rules that
were deliberately made. The spontaneous character of the resulting order must therefore be distinguished from the spontaneous origin of the rules on which it rests, and it is possible that an order which would still have to be described as spontaneous rests on rules which are entirely the result of deliberate design” (Hayek 1973:45).

9. Again, we do not mean this selective policy is recommendable. But at least it was an improvement in terms of liberating and mobilizing productive forces since a stable monetary environment, even if it was selective, did provide a stable expectation for foreign investors.

10. For instance, Premier Zhu Rongji introduced a system of close grain fund circulation and abandoned the right of private grain traders in grain trade in 1998. This was a typical total construction approach. Under such a system, the Agricultural Development Bank of China (ADBC) was solely responsible for disbursing loans to state-owned grain companies which held the exclusive power in purchasing from the hand of farm households and reselling it in the grain market. However, such government action led to unintended consequences: the state-owned grain companies were unable to capture a positive margin by buying low and selling high, and they abused the grain fund for other purposes including investing in housing and hotels. In the end, they were not able to repay loans to the ADBC. In 2004, the ADBC suffered from non-performing loans worth more than RMB 500 billion (Fan, 2004).

11. For momentum effects of the rural household responsibility system upon the dual-track system and those of the latter upon further reforms, see Roland (2000).

12. This point is the result from a discussion with Prof. Carsten Herrmann-Pillath, Sino-German School of Frankfurt School of Finance and Management in March 2008 in Beijing and reflects mainly his opinion.

13. The last chapter of Shiji (Records of Grand Historian) is huozhi Biography. By huozhi it is meant to pursue wealth and welfare through the production and exchange process.

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