The Impact of Privatisation on Economic Development in China

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China is one of the great economic success stories of the past fifty years, having undergone a radical but turbulent transformation from a centrally planned system into the second largest economy in the world by nominal GDP. Under Mao, China was an isolated socialist state; today, however, one could hardly begin to fathom China not being an instrumental player in the world economy. Niall Maher maps the evolution of the Chinese economy in the post-Mao period, arguing that the gradual privatisation of the economy was causally linked to the massive economic growth it has experienced since 1978. He offers a brief lesson in the history of the Chinese economy, outlines the possible causal links between privatisation and economic growth, and demonstrates the strong positive relationship between these two variables. To conclude, Maher argues that compelling evidence exists to prove that the transformative privatisation reforms introduced by China since 1978 caused the huge upsurge in economic growth that China has experienced in the past few decades.

I. Introduction

Since economic reforms began in 1978, China has experienced remarkable change, both in the structure of its economy and in its level of economic development. Understanding these processes, and the connection between them, is vital for understanding how states can pursue effective development policies. In this essay, it will be argued that privatisation and economic development are connected by causation, not just correlation. This argument is divided into four parts. Firstly, a brief history of the economic reforms and subsequent economic history will be given. Then, causal links between privatisation and economic growth will be established, based on four mechanisms: competition, human capital, investment, and different goals. The positive relationship between economic growth and economic development will then be outlined. Finally, counterarguments and responses to this argument will be evaluated. The essay concludes that privatisation undoubtedly improved the level of economic development in China.

II. History of Reforms and Growth

To appreciate the correlation between privatisation and growth, it is necessary to understand a brief history of the economic reforms in China since 1978. China's economic reforms are best understood as an incremental move towards a market economy. The reforms began in 1978 with the development of small-scale township and village enterprises. Although many legal restrictions on private enterprise were lifted during the 1980s, the private sector lacked the explicit support of the government and was viewed with some suspicion by the general populace, who retained the negative impression of entrepreneurs formed during the Cultural Revolution (Nee & Opper 2012: 110). Over time, the CCP relaxed the regulations constraining private firms further. By 1999, a slogan entitled 'Grasp the Large, Let go of the Small' was promoted by the Chinese state to publicise their tactic of privatising small, loss-making State-Owned Enterprises (SOEs) and maintaining control of larger, more strategically important SOEs (Hsieh & Song, 2015). More economic reforms set up stock exchanges in Shanghai and Shenzhen, incorporated SOEs as limited liability companies and redirected managerial focus from goals such as maintaining a high workforce to increasing bottom-line profits. By 2003, the private sector accounted for 59.2% of China's GDP growth, a remarkable change from 30 years previously (Brandt & Rawski, 2008: 3).

The period of reform was followed by a sustained increase in Chinese economic growth. Before the reforms, annual GDP growth was around 4%. This increased to an annual average of 9.5% from 1978-2005 (Wedeman, 2012). This growth rate increased both the absolute and relative size of the Chinese economy. For example, China's output was 37.5% of Japan's in 1978. By 2004, China's output had increased to 219.2% of Japan's (Brandt & Rawski, 2008). Although much of this increase can be credited with increases in labour and physical capital, there have also been large increases in productivity following the reforms. Productivity change accounted for 40.1% of overall GDP growth from 1978–2005, as compared to 11.4% during the period 1952–1978. China's per capita GDP relative to other countries can be examined to control for the economic impact of its population expansion. This figure increased relative to the US from 3.2% to 15.7% from 1978-2005. These statistics indicate that China went through a period of sustained, rapid economic growth following the instigation of the economic reforms.

III. The Relationship between Privatisation and Economic Growth

This section of the essay will examine the effect of privatisation on economic growth in China, relative to the Chinese system before the economic reforms. The four causal links examined are competition, human capital, investment and different goals.

Increases in competition that follow privatisation lead to increases in efficiency and innovation. In a planned economy, the goods and services of a sector are typically provided by a single state-owned monopoly. When privatisation occurred in China, it increased the number of firms providing the same product (Lee & Lardy, 2008). Competition between these firms drove prices down as they aimed to undercut each other's prices and earn a greater market share. This competition compelled firms to operate more efficiently and to deliver goods and services more innovatively. The effect of competition on efficiency has been observed in a Chinese context even when controlling for selection bias, endogeneity and adjustment costs (Jefferson & Su, 2006). Competition also has a positive effect on SOEs, as they are forced to either improve efficiency or go bankrupt. Hsieh & Song (2015) find that the entry of private firms into a sector correlates with an increase of efficiency in SOEs. The impact of competition on efficiency and innovation is one of the reasons why privatization leads to greater economic growth.

Privatisation also increases growth by encouraging human capital to operate more productively. In the Chinese planned economy, human capital was operating below its potential maximum (Feng & Mason, 2008). As managers and workers received the same payment regardless of their productivity, it was irrational to work extremely hard at their job. This effect was worsened by the chronic hunger that many workers suffered from, that in part resulted from the lack of productivity of planned agriculture (Haggard & Huang, 2008). Following the economic reforms, workers could be rewarded for completing excess work. This incentivised workers to work harder so that they could gain better material benefits. As owners had a greater incentive to operate their firms efficiently when they got to keep the company profits, they made a greater attempt to hire and promote more efficient workers. Due to this, managers in private firms are typically more skilled in important areas such as business management and marketing (Chen & Singh, 2013). The link between managerial success and rewards has been credited with private firms being relatively more market orientated than SOEs (Song et al., 2015). These effects are more apparent when a greater proportion of the company is privately-owned, which supports the idea that private ownership is positively correlated with advancements in human capital. Furthermore, these effects have been found to sustain in the long run (Bai et al., 2009).

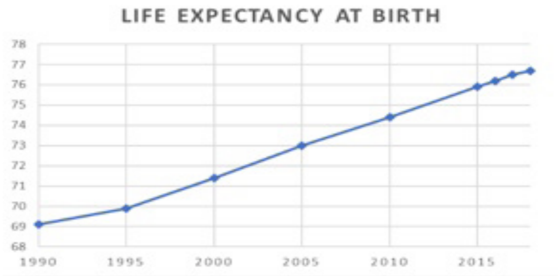
A market economy also leads to greater levels of investment, which increases economic growth. Investment provides firms with the capital to rapidly expand or engage in processes such as research and development. Private investors invest in the company with the greatest growth potential, as this usually allows them to make more profit from their investment. In a planned system, all investment decisions are managed by the government. However, states are worse at investing than private investors. Government officials have less of an incentive than private investors to vet the firms they are providing investment to, as it is not their personal money that they are investing. Therefore, a privatised system of investment allows more efficient firms to grow than in a planned system (Haggard & Huang, 2008). Furthermore, a market system helps prevent efficient firms from being crowded out by less efficient firms that receive government funding. Privatisation has also led to much greater amounts of funding being available for Chinese firms. For example, foreign direct investment from the US surged from nothing under a planned system to an annual inflow of approximately U.S.$70 billion for the period 2004-2006 (Brandt & Rawski, 2008).

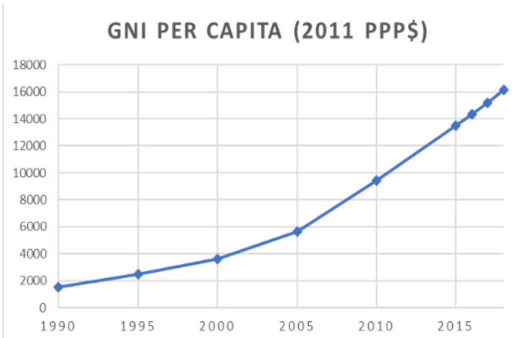
Privatised firms also have more growth-oriented goals than SOEs. The goal of private firms is to be profit maximising. This goal encourages growth in all situations where growth can be achieved cost-efficiently. SOEs typically face several, often conflicting goals. As well as trying to be profitable, they must also balance political objectives such as maintaining a low output price, a high level of employment or a high book value of state assets (Song et al., 2015). These goals can come into conflict with profitability. For example, state bureaus that oversee SOEs often prioritise having a high book value of state values, rather than maximising the market value of the company, even though maximising the market value would be more conducive to growth. The greatest challenge SOEs face when trying to become more competitive is trying to reduce their labour force (Rees et al., 2010). This indicates that the labour force of SOEs are not at a competitive size because of the different political goals that SOEs must balance.

IV. The Relationship between Economic Growth and Economic Development

Although closely intertwined, economic growth and economic development measure different processes. Economic growth measures whether production has increased in a country while economic development measures whether the quality of life of the populace has improved. Although what exactly constitutes an increase in the quality of life is contestable, typical components include increases in life expectancy, literacy and real wage. In this essay, the World Bank's Human Development Index (HDI) will be used as a guide for measuring changes in economic development, as it facilitates international comparison between countries. The HDI is formed by the mean of three dimensions of development; health (measured by life expectancy at birth), education (measured by years of schooling for adults aged 25), and standard of living (measured by gross national income per capita in purchasing power parity). These scores are normalised and aggregated into a composite index using a geometric mean (Sagar & Najam 1998). It is important to note that the HDI does have limitations in its measurement of development, such as its omission of data on inequality, political freedom and human security.

China has undergone a substantial increase in economic development following the reforms of 1978. Between 1990-2017, China's HDI value had increased from .501 to .752 (World Bank, 2018). This means that China is now in the high development category of the index. In the same period, life expectancy in the country increased by 7.1 years, mean years of schooling increased by 3 years and GNI per capita by 898.7%. These results can be seen in the following graphs:





Source: The World Bank (2018)

China's economic development has been caused to a large extent by its economic growth. Economic growth improves all three components of the HDI. Gross national income per capita increases when there is faster economic than population growth, as was the case in China. Economic growth also indirectly increases life expectancy and mean years of schooling, as increases in per capita income increase the ability to afford better healthcare and education services. Furthermore, increased tax revenues improve the government's capacity for fiscal expenditure on healthcare and education. Private businesses have a large incentive to promote policies that increase the health and education of their pool of potential employees, as this causes them to work more productively. It should be noted that the causality for these improvements run both ways, as improvements in health and education also cause increases in income. However, there is compelling evidence that a substantial proportion of the improvement in China's level of economic development stems from its huge increase in economic growth. Furthermore, privatisation can improve levels of education directly. Privatisation creates a wage premium for workers who develop skills in areas where there are talent gaps (Brandt & Rawski, 2008). This encourages people to become more educated. This incentive contrasts with the lack of education attainment found in the Chinese planned economy, particularly the stigmatisation of intellectuals during the Cultural Revolution.

V. Counterarguments and Responses

One response to the argument that privatisation has led to economic development is that privatisation has led to an intensification of corruption in China, which harmed economic development. Since the economic reforms were initiated, corruption has severely worsened in China (Dong & Torgler, 2013). The economic reforms were not accompanied by political reforms enforcing institutional and legal constraints on the government, which gave greater freedoms to officials to partake in corruption (Hao & Johnson, 1995; Wedeman, 2004). Corruption has a negative impact on economic growth and development. On average, a one-point increase in the Corruption Perceptions Index leads to a 1% decrease in economic growth (Mauro, 1995). Between 1992 and 1996, China's Corruption Perceptions Index score increased by two points. As the economic reforms led to this increase in corruption, it could be argued that privatisation harmed growth.

In response to this argument, I argue that, even if it is accepted that corruption was directly caused by privatisation policies, this increase in corruption did not enough have enough impact to counterweight the positive impact of economic growth on China's economy. From the earlier analysis of the improvement of China's Human Development Value from 1990-2017, China's score improved substantially, and economic growth was a large cause of that improvement. Although corruption may have slowed growth to some degree, China's privatisation policy resulted in a net positive impact on economic development. Even taking different measures of economic development, such as the Inequality-Adjusted Measure of Development, we find that China has dramatically increased its level of economic development in the same period (World Bank, 2018). This analysis can be extended to other negative externalities that could have been caused by privatisation, such as inflation. Even accepting that inflation was caused by privatisation and that it lowered economic development in China, it did not have a large enough negative effect on economic development to out-weigh the substantial increases in economic development that followed the economic reforms.

Another possible criticism of this argument is that the increases in China's growth rate could have been caused by global or regional macro-economic trends and would have occurred regardless of whether China underwent privatisation. In response to this, firstly it disregards the evidence outlined above linking privatisation and growth. Secondly, if this were true then we would see similar relative increases in the growth of other countries. Between 1990 and 2017, China increased from the 103rd to the 86th most economically developed country. Furthermore, China's HDI score was significantly higher than other countries in East Asia by 2017. This relative increase in size indicated that there are factors specific to China that are causing this economic growth, such as the fact it was undergoing economic reform over the last 40 years.

VI. Conclusion

Since 1978, China has gone through gradual, but transformative economic reforms. The goal of this essay has been to outline the effect of these reforms on economic development and to answer whether they are causally connected to the economic development that followed them. It has been demonstrated that there is compelling evidence that a connection exists. To recap, the essay began with an outline of the economic reform and growth that China underwent. Then, four mechanisms were outlined linking privatisation to economic growth; increased competition, human capital, investment, different goals. Following this, the causal link between economic growth and economic development was explored. Finally, the counterarguments and limitations of my argument were evaluated, which I believe I successfully rebutted. Synthesizing the evidence presented in the literature, I conclude that privatisation had a positive causal effect on economic development in China.

VII. References

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