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Rapid Growth as Destabilising Force: China's Economic Transformation Reconsidered

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Introduction

Political and economic change in the People's Republic of China (PRC) has become one of the major driving forces in the Asian/Pacific rim. Undoubtedly, the PRC now has a great influence on stability and prosperity in the region. In the meantime, it is also becoming increasingly apparent that the East Asian development model is of greater relevance to the PRC's economic transformation, in terms of change both in institutional setting and economic structure, than Western capitalism. This is not only because culturally and historically the PRC shares a similar background to her successful neighbours, but also, perhaps more significantly, because the history of economic development has clearly shown that the state, in late-developing, as opposed to early-developing countries, can play a more dynamic role in fostering economic growth and facilitating structural changes. Relative economic backwardness itself may even be an advantage to development in the sense that countries slow in economic development can save time by learning modern technologies and buying advanced products from developed countries (Gerschenkron 1962). However, only when the institutional settings create incentives to growth and the state subsitutes for the lack of some necessary development prerequisites (entrepreneurs, private capability of capital formation and demand for modern technologies, etc.), can this potential advantage become a real catching-up process.

The transition from central planning to market economy does not necessarily mean accepting the Western models. "Civil societies can come in different shapes and forms, as do their component market institutions of private property and contractual liberty, so that no one variant of civil society is likely to be appropriate for all the post-Communist states, with their greatly differing circumstances. What has been argued, rather than

1 The author is grateful to A. Kraft and J. Steiger for their very helpful comments and discussion of an earlier draft of this paper. All errors in this paper remain those of the author.

merely taken for granted, is that specifically Western models of civil society and of market institutions have little relevance to most of the post-Communist states, while some non-Western models may possess a measure of relevance" (Gray 1993:47).

The experiences of Japan and the first generation of East Asian Newly Industrialising Economies (NIEs) in modernising their economies have emerged as a non-Western model for the former centrally planned economies.[2] The creation of the so-called East Asian miracle is largely related to diverse and flexible government interventions in the market process. Such an interventionism goes far beyond either the market-equilibrium explanation of invisible hand or beyond the Keynesian proposition of macroeconomic management. The states in these countries have done more than correct market failures and imperfections: they have stimulated economic growth and regulated structural changes directly. The most important lessons from Japan and the East Asian NIEs, however, are not confined to the policies and interventions that have been undertaken. The success in development management of these countries lies partly in the policy measures and partly in the institutional mechanisms they created to implement policies and interventions effectively (Wade 1990; Park 1990; World Bank 1993:353-368).

How to meet the institutional requirements for effective development management as well as for social equity, while dismantling a Soviet-style planning system, remains one of the central issues in the political economy of the PRC. In fact, market-oriented reforms and rapid growth have led to uncertainty about the country's future. The present dynamics of the Chinese political economy lies not only in the changing nature of the traditional determinants, such as leadership and ideology of the Communist Party, central planning institutions and dominant state sector in the economy, but also in the emergence of other economic powers such as economic regionalism, market-driven non-state sectors and foreign capital.

Never before has change in economic policy played such an important role in activating and diversifying the Chinese economy as it does today. However, while the government has been successful in granting greater autonomy to enterprises and individuals, economic reforms have failed to achieve a decisive breakthrough to a new institutional form of developmental state and the desired new relationship between state and economy (White 1995:5-9). The central government is gradually losing its influence on the development process, although the country is now facing many severe economic problems that erode its long-term growth potential, such

2 See World Bank (1993) for the definition of the East Asian NIEs. In this paper the East Asian NIEs refer only to Hong Kong, Singapore, South Korea, and Taiwan.

as the lack of macro control, in particular over growing inflation, inadequate physical infrastructure, widespread corrupt practices and sharply increasing income inequality. This trend will cause instability in the near future if the increasing tensions between traditional and emerging agents of change cannot be eased. The old determinants must adapt themselves to the new environment and build the new institutional mechanisms necessary to manage a market-driven economy effectively.

This paper seeks to examine some main obstacles to effective development management in the Chinese economy from the institutional perspective. The first section gives a brief on a state-led development model in the context of the experience of Japan and the East Asian NIEs. The second section addresses a characteristic of the dual determination in the present political economy of the PRC and its effects on the formation of the institutional mechanisms to achieve long-term development goals. The third section points out some major factors leading to increasing weakness of the Chinese state. The last section comes to some conclusions emphasising that sustainable economic growth rests largely on the creation and improvement of institutional fundamentals that enable the government to undertake effective industrial policy and to maintain macro stability and social equity.

Institutional Requirements of a State-led Development Model

The development experience of Japan and the East Asian NIEs has shown that states can facilitate growth by "governing the market" and "getting prices wrong" and by systematically distorting incentives to speed the economic take-off. In these countries, economic expansion has largely relied on governmental interventions to create price distortions that lead to higher saving and investment rates. State intervention has proved necessary even in the most plausible cases of comparative advantage, "because the chief asset of backwardness – low wages – is counterbalanced by heavy liabilities" (Amsden 1989:14). There are many cases demonstrating how the states of Japan and the East Asian NIEs intervened effectively in the market process. South Korea, for example, strongly encouraged heavy and chemical industries by setting targets and offering a variety of financial incentives. Japan selectively promoted the development of several weak industries in the first fifteen years after World War II by offering protective targets and financial incentives to encourage the introduction of advanced technologies and creating rationalisation cartels to facilitate the exit of inefficient firms. Taiwan used public investment in large-scale manufacturing enterprises to ensure inputs for predominantly small and medium-scale exporting industries.[3]

Although most explanations of the economic miracle of Japan and East Asian NIEs have emphasised both outward or export orientation of the economies and effective state intervention, more recent study has found that the rapid economic growth since the 1960s, expecially in South Korea and Taiwan, followed domestic investment booms that took place largely because of the government's industrial policy (Rodrik 1995). By subsidising and coordinating investment decisions, government policy managed to engineer a significant increase in the return to capital. Exports were initially too small to have a significant effect on the whole economy. The outward-oriented development of these economies was therefore the consequence of the increase in domestic demand for import capital goods. In other words, the rapid growth is to be attributed more directly to government intervention in domestic investment decisions than to the gains from exports.

Obviously, the success stories of Japan and the East Asian NIEs have provided a model for development management in terms of effective industrial policies. But this model is not a simple framework of policies and intervention. In these countries, the policy mixes were very diverse and flexible.[4] the state-led development model is mostly characterised by an institutional setting which provides government with policy instruments, such as control over credit and budgetary allocation for development goals and linking of the economic bureaucracy with private sectors. The high quality of technocratic bureaucracies and the authoritarian nature of the political institutions of the state are also crucial in devising policy and intervention (Wade 1990:193-227, Vogel 1991:92-106).

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3 Although the governments of both South Korea and Taiwan have contributed to rapid growth and industrialisation through intervention, the role of the state in these countries in producing growth and structural changes has differed. In South Korea the government has played a leading role in terms of more direct control over the allocation of resources. In Taiwan the government has in general confined its role to providing social and physical infrastructure and other public goods, the intervention has largely depended on setting macroeconomic targets and formulating indicative investment plans (Park 1990).

4 World Bank (1993:10-11) classified the policies used by the governments of the East Asian NICs and Japan to guide resource allocation into two broad groups: fundamentals and selective interventions. Among the most important fundamental policies are those that promote macroeconomic stability, high investment in human capital, a stable and secure financial system, limited price distortions, and openness to foreign technology. Selective interventions include mild financial repression (keeping interest rates positive but low), directed credit, selective industrial promotion, and trade policies that push non-traditional exports.

In the state-led development model, the economic bureaucracy and political arrangements, influenced much more by "national interests" than group interests, are central to effective development management. In the East Asian NIEs, a small number of powerful policy-making agencies, staffed by the best managerial talent in a system of entrance examinations, perform "think tank" functions, chart the routes for economic development, decide which industries ought to exist and which industries are no longer needed in order to promote the industrial structure that strengthens the nation's international competitiveness, obtain a consensus for their plan from private sectors, act as gate-keepers for contacts with foreign markets and invest and provide positive government supports for private economic initiative. But the coherence of state economic policy and interventions is difficult to maintain when important parts of the state are beholden to sectoral, ethnic, or regional interests. The economic bureaucracy of the East Asian NIEs has fitted into a wider set of political arrangements inluding authoritarian and corporatist. The rules for selecting the rulers give little scope for the expression of popular preferences. Interest groups are not voluntary associations, but are chartered or even created by the government. This type of political arrangement not only enabled the development-committed political leadership to maintain long-term political stability, but also to exercise much influence over public investment decisions and policy choices.

Rapid Economic Growth and Institutional Transformation in China

The Chinese economy differs from the East Asian NIEs in many aspects. Besides its political circumstances, an obvious and principal feature that makes the Chinese economy different from its neighbours is its size.[5] A second difference lies in its Soviet-style planning system. The transition from a Soviet-style command economy to a market regime not only means redefining the role of the state in the economy, but also implies uncertainty in economic institutions during the transition period. The dynamics

5 See Perkins and Syroquin (1989:1691-1753) for the influence of size on structural changes and economic growth in large countries. The analysis comes to the conclusion that, although the relationship between country size and the share of foreign trade in GNP is generally negative, there is almost no difference between the share of industry, agriculture and services in national product. But size makes a difference between large and small countries in the structure of foreign trade itself. Though they have less choice in determining their development strategy, large countries appear to enjoy the advantages of both economies of scale and endowments of production factors, in particular natural resources and labour forces, not available to small ones.

of the economic system, including changes of allocation mechanism and property rights, are quite contrary to the experience of the East Asian NIEs, in which institutional transformation proceeded mostly under the legitimate control of the authoritarian state without a fundamental change of the political and economic system. The political economy of the PRC is much more uncertain than that of her successful neighbours in the past. While the traditional socialist state (the Party's leadership, the central government and the central planning institutions) remains the primary agent of change, rising economic powers such as regionalism, a rapidly expanding private sector and widespread rent-seeking practices of governmental organisations and officials play increasingly important roles in the economy.

The transformation of political and economical institutions has taken place, but the precise consequences are far from certain, because the long-term trend of change meets with a dilemma: the economic inefficiency of central planning has forced the state to lift most existing central controls over the economy and to give the market more freedom in allocating resources, but sustained economic growth in the long run is conditioned by political, economic and social stability, rapid structural changes, balanced regional development and equity of income distribution. These require in turn a strong central government to exert effective macro, industrial and social policies. It is becoming increasingly difficult for the Chinese state to maintain policy capacity in terms of constructive interventions in the economy, when the country is changing so rapidly.[6]

The economic liberalisation introduced since the late 1970s has been associated with rapid economic growth. The economy recorded average annual GNP growth of about 10 percent in the period of 1979-1994. Following a retrenchment programme that reduced growth to 4.4 percent in 1989 and 4.1 percent in 1990, the economy has resumed very rapid growth, reaching a breakneck 13 percent in 1993. The share of export in GNP increased from 5 percent in 1978 to about 25 percent in 1994 (Table 1). But this rapid growth has occurred mainly in non-state sectors, especially in rural industry, which has developed without central planning. It can be attributed mostly to the economic structure dominated by agricul-

6 In the 1980s and early 1990s, the central government launched several austerity programmes in order to cool an overheating economy and to maintain macro stability. These programmes were dominated by administrative tools containing price controls, freezing of investments and credit and strict restrictions on imports. All of them were short-lived because of the lack of an institutional framework of policy instruments, in particular banking and taxation systems. Although the central planning system still has an enormous influence on the state-owned sector, administrative instruments have proved to be less effective for private and collective firms that now play a leading role in the economy.

Table 1: China's Main Economic Indicators 1975-1995

	Real National Income (Growth Rate, %)	*Real GNP (Growth Rate, %)*	*Inflation Rate (Index of Living Cost, %)*	*Inflation Rate (Index of Free Market Prices, %)*	*Money Supply (Growth Rate of M2, %)*	*Exports/ GNP (%)*	*Foreign Reserves* (Billion $)*
1975	8.3		0.2				
1976	-0.3		0.3	4.0			
1977	7.8		2.0	-2.4			
1978	12.3		0.7	-6.6			
1979	7.0	7.6	2.0	-4.5	9.7	5.3	0.84
1980	6.4	7.9	6.0	1.9	24.1	6.1	-1.30
1981	4.9	4.4	2.4	5.8	19.7	7.7	2.71
1982	8.3	8.7	1.9	3.3	13.1	8.0	6.99
1983	9.8	10.3	1.5	4.2	19.2	7.6	8.90
1984	13.4	14.6	2.8	-0.4	42.4	8.3	8.22
1985	13.1	12.7	8.8	17.2	17.0	9.5	2.64
1986	7.9	8.3	6.0	8.1	30.2	11.2	2.07
1987	10.2	11.0	7.3	16.3	25.3	13.0	2.92
1988	11.1	11.0	18.5	30.3	20.7	12.6	3.37
1989	3.7	4.4	17.8	10.8	18.7	12.3	5.55
1990	5.1	5.6	2.1	-5.7	28.9	16.9	11.09
1991	7.9	7.3	2.9	-0.9	26.7	19.3	21.71
1992	15.4	13.0	5.4	2.4	31.3	19.2	19.40
1993	15.1	13.4	14.7	12.5	24.0	16.8	21.20
1994		11.8	24.1	21.5	34.4	25.0	51.60
1995**		11.0	25.0	20.0	35.0		
Average 1979-1993	9.3	9.4	6.7	6.8	23.4		

Notes: * Foreign reserves held by Bank of China are excluded; ** Author's estimates
Sources: Statistical Yearbook of China (various years); McKinnon, R. I. (1994:441)

ture rather than the gradualist liberalisation itself and government policies.[7]

Rapid growth means rapid economic change that also entails political and social dislocation. Not all members of society can gain from the growth. Both winners and losers could be destabilising for the existing economic, political and social orders. The political and economic change in the PRC clearly meets two premises that were made early by Olson and have been generally ignored in analysing political and económic development in extremely dynamic institutional circumstances.

First, rapid growth in the take-off stage of economic development is not necessarily a stabilising force as has usually been thought. This is not only because "economic growth increases the number of *nouveaux riches*, who may use their economic power to change the social and political order in their interest", but also because "economic growth may paradoxically create a surprisingly large number of *nouveaux pauvres*, who will be much more resentful of their poverty than those who have known nothing else" (Olson 1963:533). Therefore, political instability could be a consequence of rapid economic growth, if changes in the distributional structure of economic income, wealth and power also take place: "In time, those groups who gained the fruits of economic growth (or their children) will probably have built a new social and political order that is suited to the new distribution of economic power. But, especially if the economic growth is very rapid, the path to any new equilibrium may be highly unstable" (Olson 1963:533).

Second, economic instability as well as political instability could weaken special-interest organisations, "if there is sufficiently drastic and rapid changes in an economy, so that utterly new industries, occupations, and modes of living rapidly arise, the existing distributional coalitions may find the new activities beyond their scope and control. ... When economic growth is not only rapid but also characterized by large discontinuities, it could tend to bypass existing special-interest groups and leave them relatively less important in the society than previously" (Olson: 1982:254).

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7 Using the classical dual-economy model incorporating Gerschenkron's hypothesis, "advantage of backwardness", Sachs and Woo (1994) maintained that rapid economic growth in China was possible because the large agricultural sector contained vast surplus labour. Once constraints on migration across regions and jobs were removed, this labour was available to fuel expansion of industry. China started economic reform as a peasant agricultural society, Eastern Europe and the former Soviet Union as urban and overindustrialised. China faced the classic problem of normal economic development: the transfer of labour force from low-productivity agriculture to higher-productivity industry. In Eastern Europe and the former Soviet Union the problem is structural adjustment: cutting employment in inefficient industries to allow new jobs in the efficient ones.

The present political economy of the PRC is characterised by a dual determination of traditional and rising agents of change. New economic powers that go beyond the control of the traditional political and economic institutions have emerged in the process of economic liberalisation and growth. In the pre-reform period, the PRC's political and economic development was determined by the traditional agents of change in a totalitarian socialist system: politically, the ideology, leadership and the way the leaders of the ruling Communist Party mediate the power relationship among themselves and mobilise the popular and bureaucratic support to make and implement national policies; economically, the central planning institutions that were subordinated to the political ones, allocating economic resources according to political decisions. These have changed since the late 1970s. In order to achieve legitimacy and continuity of rule, the ideology of the PRC's communist regime has turned from hard-line Stalinism to economic pragmatism that considers rapid economic growth and improvement of the standard of living as the highest objective of national politics. The leadership and its implementation of national policies have also shifted from the party-state into a national state in the sense of gradually institutionalising the policy process (Dittmer 1992). Meanwhile, economic liberalisation has also dramatically changed the government's management of the economy.

On the other hand, the economic power structure has changed largely because of the rise of new economic determinants. Both political and economic changes are now no longer solely decided by party politics, such as the power struggles of the reformers and conservative hard-liners. Rather, the emerging factors, such as a rapidly expanding private economic sector, increasing foreign capital, economic regionalism, and last but not least individual or group motivations to be gainers, instead of losers, in the rapidly growing economy, play an increasingly important role in the political and economic development of the PRC. That the marketisation process returned so quickly to its course after the political suppression and economic recentralisation in 1989 has shown that the emerging economic powers could influence the country's political and economic process to a greater extent. In short, there will be no U-turn for the market-oriented economic reforms in the long run.

Incremental Weakness of the Chinese State

The relationship between the political and economic aspects of the state are complex. They may undermine each other in various ways. Failure to achieve proclaimed economic goals may undermine the credibility of the regime. On the other hand, economic success may strengthen the legitimacy and continuity of the regime, as witnessed by the longevity of the authoritarian system in the East Asian NIEs, in which the state as a political and developmental entity is very ambiguous. In the PRC the state has to maintain or to build the institutional fundaments and mechanisms to facilitate sustainable economic growth. However, even if the economic failures of the Soviet-style central planning system have forced the state to change its role in the economy and the economy has been liberalised successfully, the PRC has failed to transform her political and economic institutions into a development state in the sense of building institutional fundaments and policy capacity to undertake effective governmental interventions in the process of economic catching-up.

Regionalisation of the Economy: Conflict between the Central and Provincial Governments

One obvious example is the emergence of an intense economic regionalism in the sense that rich coastal provinces steam off on their own in the scramble for prosperity, sometimes at the cost of the economic interests of the country and other regions. There has been a major shift of economic power from central to local government at provincial level and below, partly as a result of conscious policy and partly as one aspect of a more general dispersion of economic power within the state machine. While economic regionalism facilitates economic development and international integration by flexible policy and strategy based on different factor endowments and speeds up marketisation of the economy by escaping from rigid central controls, its negative consequences are also obvious. Incremental policy weakness of the central government and the tendency to economic regionalism enhance the possibility of disintegration of the economy. This may lead to political and macroeconomic instability and a deterioration in the regional structures of the economy and, therefore, to obstruction of sustainable economic growth and structural change in the future.

Regionalism has resulted in economic protectionism within the country. It becomes common for provinces to restrict imports from another province, to levy high, though informal, taxes on goods whose production is seen as important to the domestic provincial economy, and to create non-tariff barriers. Xinjiang, for example, effectively banned the import of forty-eight commodities because they would harm its domestic economy. Jilin refused to market beer produced in the neighbouring provinces. In the regions, local authorities established and financed a variety of schemes that promoted the sales of local products. Enterprises from other provinces often have difficulties in finding office space, accommodation, or land for their activities. Competition between provinces can be fierce, and there are numerous tales of "commodities wars" between provinces over, amongst other items, rice, wool, soy beans, tobacco, coal and steel (Goodman 1994: 6-7).

Declining Financial Capacity of the Central Government

The dispersion of economic power has seriously reduced the policy capacity of the central government and eroded its bargaining position with those rich provinces. The weakness of the central government is twofold: it is not merely a matter of not being able to secure administrative compliance down the long chain of bureaucratic command, but also of garnering the financial resources necessary to underpin central policies. Part of the loss of control involves the inability to extract government revenue from an increasingly complex and recalcitrant economic system. The state has found itself facing a fiscal crisis, dwindling sources of revenue being accompanied by escalating demands on the treasury. There have been increasingly vocal demands for extra resources from sectoral interests (education is a good example). Expenditure also includes budgetary subsidies for unprofitable state enterprises and consumer subsidies to cushion the urban population from the rise in agricultural prices and inflationary pressures.

When revenue-sharing between the central government and the provinces based on taxation was introduced in the 1980s, the central government was forced to increase budgetary deficits. Inevitably, the revenue-sharing system has disproportionately benefited those provinces that have grown fastest during the 1980s – Guangdong, Fujian, Zhejiang and Jiangsu. Central government has stated several times that it would prefer to see the system replaced by one based on profit-sharing to reduce its budgetary burden. Neither has proved politically possible, even though central government had the support of several provinces, such as Shanghai and Liaoning, which were resentful of what they considered to be the preferential treatment afforded to the fast-growing regions. In the early 1990s, as part of the discussions that resulted in the Eighth Five-Year Plan, the central government attempted, unsuccessfully, to renegotiate its financial arrangements with a number of the wealthier provinces.

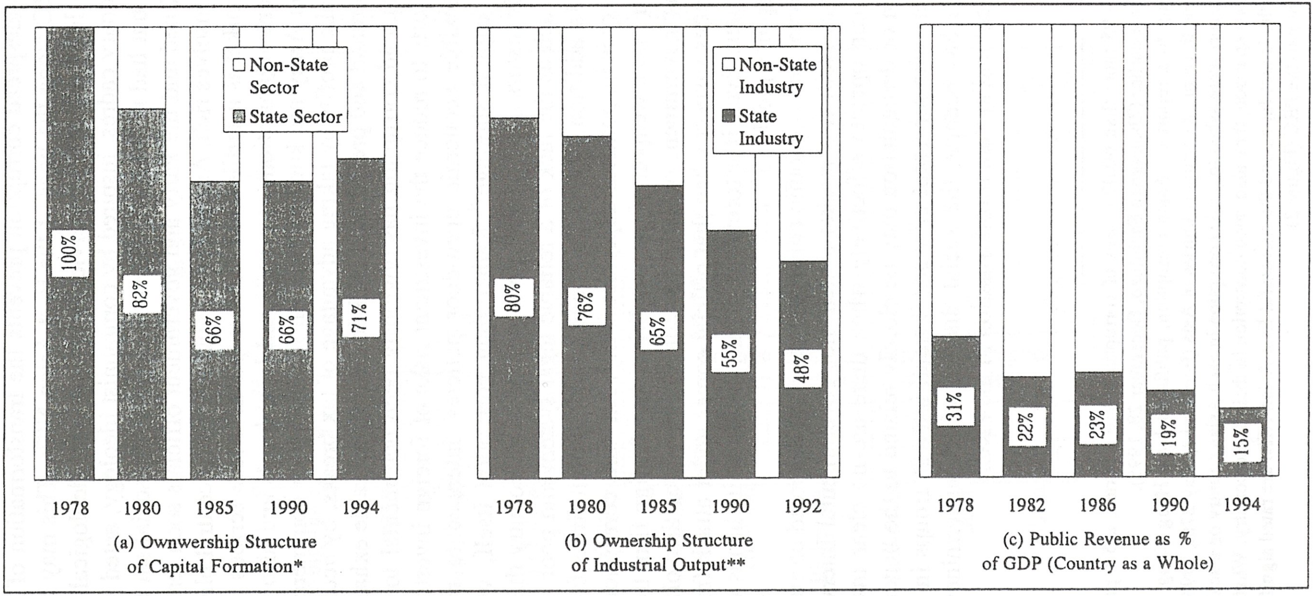
The ratio of the central government's budgetary revenue to GDP decreased from 31 percent in 1978 to about 15 percent in 1991. The central government's real budgetary revenue at 1987 constant prices increased at an average rate of 2.5 percent between 1978 and 1990, which is much lower than the real GDP growth. The degree of localisation of both budgetary revenue and expenditure increased dramatically in the 1980s and early 1990s (Prime 1991) (Figure 1).

Economic decentralisation has shifted the control over investment from the centre to the local governments. The decline in the proportion of centrally controlled fixed investment has been the most striking change in the Chinese economy since 1978 (Naughton 1995: 259-263). The share of total state investment has largely declined since 1978 (Figure 1). Subsidies of loss-making state enterprises and backward regions account for a considerable part of the central government's budgetary expenditures. The financial capacity of the central government to invest in nation-wide infrastructure has obviously deteriorated.

Corruption stimulated by the vague boundaries between plan and market

The transformation of the PRC's bureaucracy is under way. Since 1978, to speed modernisation of the economy the Party leadership has found it necessary to raise the educational level of its members and government officials by changing recruitment policy. Many important positions are now occupied by younger cadres who have college-level education, especially in the scientific and technical fields. But socialist bureaucrats are quite different from Max Weber's bureaucratic technocrats. After the foundation of the PRC in 1949, the regime never attempted to restore the entrance exam system, the traditional gateway for bureaucrats in a Confucian society, and instead introduced a recruitment system dependent more on communist ideology and political loyalty to the Party's leaders than education, technical expertise and political neutrality (Lee 1992). By contrast, in Japan and the East Asian NIEs, the entrance exam system for civil servants remains one of the striking features of Neo-Confucian industrialised society. The contents of the examinations have, of course, been altered: Confucian teachings and stylised essays have been replaced by knowledge of foreign languages, economics and science (Vogel 1991:96-97). The transformation of the PRC's bureaucracy requires a fundamental change in the cadre system and the creation of technocrats that have the competence to formulate effective policies and the integrity to implement them.

Figure 1: Declining State Sector in the Chinese Economy



Notes: * Non-state sector includes private and collective economy; ** Industrial output before 1990 only refers to that of urban industrial enterprises
Source: Statistical Yearbooks of China (various years)

But widespread corruption prevents the transformation of bureaucracy in the PRC along the lines of the East Asian NIEs. This may be attributed partly to low pay in civil service and partly to ideological demolition. Revolutionary cadres, inspired by communist ideology, acted as the political elite, but had no vested interests in society. As socialism failed, ideology declined and the Party and government officials soon learned how to make themselves rich. An economy caught between central planning and a muddy market is a fertile land for corruption.[8] More serious is that many government organisations at central and local levels and also the People's Liberation Army are known to search for their own commercial interests and to make profits by taking advantage of tax breaks, by access to goods in high demand and preferential bank loans or favourable exhange rates.

Widespread corruption has obviously been detrimental to the government's efforts to reduce the investment risks of foreign investors by introducing flexible economic open-door policies, intended to make up for domestic capital shortage.[9] Rather than corruption itself, what bothers Western investors most are the shortcomings in the country that allow it to flourish, such as the lack of a reliable legal system and poor pay for civil servants. In addition, one of the biggest risks foreign firms face in a corrupt country is its political unpredictability. An "anti-corruption drive" can easily turn into a weapon of party politics. Any foreign firm that has dealt with some government officials (or enterprises under that official's control) becomes suspect when that official comes under attack from his political enemies. Even if a foreign company has kept its hands clean it can still end up in a pickle.

The social and economic consequences of widespread corrupt practices are obvious. Neither a market system nor governmental intervention mechanisms can operate effectively when there are no clear market codes. Regulation or deregulation may be closely related to the benefits of decision-makers who represent only some small interest groups in the society. Corruption has become the social disease which undermines economic development and system transformation in the PRC.

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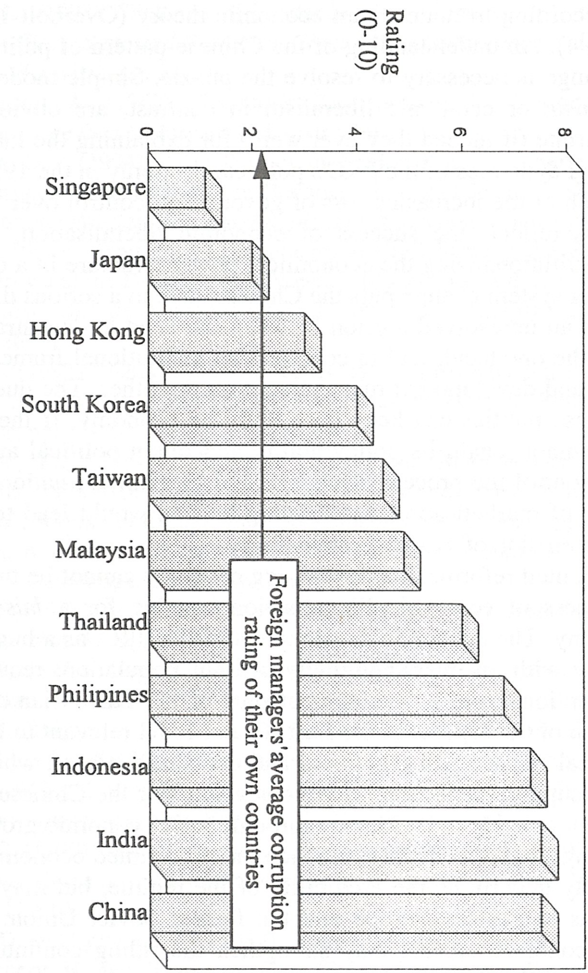
8 In the 1995 more than 60.000 cases of corruption were reported, a 5.5 percent increase from a year earlier (Zhongguao Fazhibiao, December 28, 1995).

9 According to a report on Asian corruption, published by a Hong Kong firm, China is among the three most corrupt countries in Asia (Economist, May 27th, 1995, p. 71). Western managers were asked to grade corruption in each Asian country on a scale from zero to ten. For comparison, they also rated corruption in their home country. What is particularly noteworthy is that Japan and the successful East Asian NIEs are rated significantly low by comparison to the PRC (Figure 2).

Figure 2: Western Managers' Rating of Corruption in Asian Countries
(compared with their own countries)



Source: The Economist (May 27, 1995, p. 71), quoting a report published by the Hong Kong-based Political & Economic Risk Consultancy

Concluding Remarks

The economic performance of the PRC in the past two decades has been called a puzzle in the sense that her political and economic institutions are inadequate according to mainstream economic theory (Overholt 1993:25-54; Nolan 1994). An understanding of the Chinese pattern of political and economic change is necessary to resolve the puzzle. Simple models, such as totalitarianism or economic liberalism in contrast, are obviously no longer appropriate (if indeed they ever were) for explaining the increasing complexity and dynamics of the PRC's political economy in the 1990s.

While much of the increasing loss of government control over the economic process reflects the success of economic liberalisation, the difficulty of reinstitutionalising the economical power structure in a dynamic environment of system change puts the Chinese state in a serious dilemma, which reflects an unresolved tension between the need to decentralise the economy, on the one hand, and to construct an institutional framework of macro policy and development management on the other. The question is whether Chinese politics can keep pace with the economy. If the central government cannot regain its policy ability and retain political authority, necessary to control the process of change and to maintain national unity in the process of marketisation, the ensuing tension would lead to macro instability and erosion of growth sustainability.

Market-oriented reforms in a developing economy cannot be treated as a simple process of economic liberalisation heading for a *laissez-faire* market economy. The economic development of the PRC, as a huge developing country with an overwhelmingly peasant population, requires effective interventions from a development state of the East Asian development type. One of the aspects of the East Asian Model relevant to the PRC is the reciprocal impact of the political and economic sphere, which may undermine or support each other in various ways. For the Chinese regime it is now urgent to achieve legitimacy through rapid economic growth and improved living standards. Failure to reach the proclaimed economic goals may not merely undermine the credibility of the regime, but may lead to its collapse, as in Eastern Europe and the former Soviet Union. On the other hand, economic success may strengthen the ruling continuity of a regime that has fallen into a crisis, as shown by the authoritarian systems in the East Asian NIEs. It will thus be essential for the Chinese state to create institutional fundamentals and build policy capacity to undertake effective development management if it is to maintain long-term political stability.

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