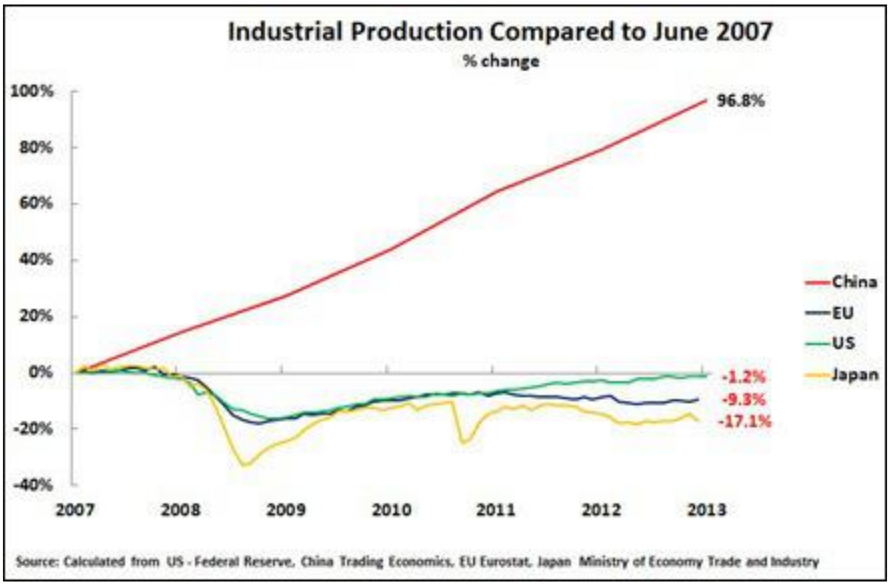
China: three models of development
by Michael Roberts

In the past 30 years, China's growth has been phenomenal. And since the global financial crisis and the Great Recession in the major capitalist economies, China has continued to close the output gap with the leading capitalist economies.[1].

Even if China's average real economic growth were to slow from here to about 7% a year instead of the double-digit expansion of the last decade, that gap will continue to narrow. The working population is still growing, although it will soon peak; there are still hundreds of millions of rural workers and peasants to be incorporated into the industrial machine; and China is still sucking up as much the world's raw materials as it needs to sustain its expansion.



So the great Chinese economic 'miracle' is not exhausted quite yet. But what explains this miracle? There are several explanations that have been offered.

The neoclassical comparative advantage explanation

World Bank economist Lin[2] argues that China's miracle is down to a switch in economic policy by its under Deng Xiaoping in the late 1970s and early 1980s away from what he calls a comparative advantage defying strategy (CAD) towards a comparative advantage following strategy (CAF). By this he means that China's leaders realised that the bias in state intervention towards developing heavy industry at the expense of agriculture, or increasing

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[1] *(http://ablog.typepad.com/keytrendsinglobalisation/2013/09/china-has-overtaken-the-us.html). On World Bank data China's industrial production in 2007 was only 60% of the US level, whereas by 2011 it was 121%. Therefore in only a six year period China has moved from its industrial production being less than two thirds of the US to overtaking the US by a substantial margin. … In six years China's industrial output almost doubled while industrial production in the US, Europe and Japan has not even regained pre-crisis levels."*

[2] *Yifu Lin is the founder of the China Center for Economic Research and former professor of economics at Peking University. He has a PhD in economics from the University of Chicago, and until recently was the chief economist at the World Bank.*

capital inputs instead of using the plentiful supplies of cheap labour eventually created distortions in the prices of products, weakened agricultural prices and rural incomes relative to industry, kept consumption too low and generated over accumulation with low capital productivity. This led of a range of 'unviable' industries that could not compete in world markets. Under Deng, China took advantage of its real comparative advantage, the labour factor of production. Economic growth took off and China competed successfully in world markets through a powerful combination of foreign investment and cheap labour.

Previously, Mao had pursued a wrong strategy for his time. Lack of industrialization, especially large heavy industries that supported military strength, was seen as the root cause of China's then backwardness. Previously, leaders in France, Germany, the U.S. and other Western nations pursued the same strategy, motivated by the contrast between Britain's rising industrial power and the backwardness of their own industry. China, however, attempted to do so prior to attaining basic industrial competencies.

China's government gave firms in those sectors a monopoly and subsidized them with lower-priced inputs, often creating shortages. This allowed China to establish modern industries, test nuclear bombs in the 1960s, and launch satellites in the 1970s. But its labour-intensive sectors were repressed - and that was where it held a comparative advantage. Thus, efficiency was low and growth prior to 1979 was driven mainly by increased inputs. Without protection, those new industry firms would not have been viable.

But under Deng, China then embarked on a 'dual-track system', introducing reforms in some areas while maintaining the status-quo in others - aimed at controlling the shock delivered at one time. Farmers were one of the first beneficiaries - they were allowed to own their land again (collective farms were broken up) and could set prices for selling their production that exceeded quota obligations sold to the state at fixed prices. Meanwhile, entry of private enterprises, joint ventures, and foreign investment into labour-intensive sectors was allowed.

According to Lin[3],you can construct a 'technological choice index' based on the capital intensity of the manufacturing sector to measure a country's choice of development strategy and in turn the quality of policy and institutional environment of that country. This index not only reflects how much the government's preference for developing capital-intensive industries is, but also can be used to measure how much the economy is distorted by the government. Given the development stage of a country, the higher this index is, the more an economy is distorted.

Lin found this index well explained the economic growth in a cross-country empirical analysis. The government had to collect heavy explicit taxes from the economic sectors that were generating a surplus and create direct financial subsidies for the non-viable industries. But such a surplus would have come only from the small and scattered agricultural sector, making tax collection difficult and costly. The key to supporting the non-viable firms was to completely reject market mechanisms by artificially distorting the relative prices of factors and products.

Developing capital-intensive heavy industries was extremely costly, and such industries could not hope to be viable in an open, free market economy. Thus, the government had to distort the economic institution, and nationalize the resources, so as to sustain the non-viable

[3] (2003),

industry. According to Lin and others following this explanation, this was a flawed development strategy is responsible for the increasing disparities in economic development among the provinces in China. [4]

The priority industries under this strategy were inconsistent with the comparative advantage determined by the factor endowments in those provinces. Consequently, the 'leap-forward' strategy retarded the functions of market, impeded capital accumulation and hindered technology and productivity progress in the provinces. Therefore, it was imperative to replace the comparative advantage-defying leap-forward strategy with a comparative advantage-following strategy and restructure the existing industries in each province according to the principle of comparative advantage.

The key criterion for development then must relate to 'viability' in the capitalist market. Lin formally defined the term 'viability' as "if, without any external subsidies or protections, a normally managed enterprise is expected to earn a socially acceptable profit in a free, open, and competitive market, the enterprise is viable. Otherwise, the enterprise is nonviable." Normally, if an enterprise in the long term does not expect to earn a socially acceptable profit, the enterprise will not be set up or will be driven out of the competitive market. However, if a government adopts a CAD strategy, encouraging enterprises in the economy to ignore the existing comparative advantages of the economy in their entry/choice of industry/technology, these enterprises will not be viable in an open, free, competitive market.

But was the adoption of neoclassical economic theory and the 'law of comparative advantage' (first developed by David Ricardo in the early 1800s when the first great industrial capitalist economy, Britain, was 'taking off') really the explanation of the take-off of China from the 1980s onwards? First, China's growth prior to the Deng 'reforms' has not been that awful. As Lin admitted, GDP did increase an annual average of 6.1% from 1952-78.

Second, is the law of comparative advantage useful? As Tyler Cowen recently put it[5], a leading neoclassical economist of the 1950s and 1960s, Paul Samuelson considered comparative advantage as an example of an economic theorem which was both true and non-trivial. It had little explanatory value. As a static model, it takes no account of the dynamic perspective. The law assumes perfect mobility of labour, and "sits uneasily with the observation that long-term unemployment is indeed possible." Furthermore even defining comparative advantage is problematic. How do you measure the *quality* of labour or capital? For example, how can we decide whether the US is a capital-intensive or labour-intensive nation, when taking qualities into account?

Third, beyond a single input world, we need market prices to measure comparative advantage. But then the original comparative advantages are endogenous to specialization decisions and other economic factors. The true theory of comparative advantage, for a multi-factor world, isn't nearly so simple.

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[4] Lin

[5] Tyler Cowen on September 1, 2013 at 3:38 am in Uncategorized | Permalink- See more at: http://marginalrevolution.com/marginalrevolution/2013/09/why-the-theory-of-comparative-advantage-is-overrated.html#sthash.dFYLPMgB.dpuf

It also can be said that the initial comparative advantages are in fact endogenous to trade. But many of the most important gains from trade come from other mechanisms, including specialization, increasing returns, or the generation of commercial networks which lead to a later transmission of ideas and technologies.

Contrary to Lin's expectation, the implementation of CAF policies in China would not necessarily lead to rising prices for goods in low labour cost and rural areas but mass unemployment in the industrial urban areas. Applying the law of comparative advantage does not mean a smooth equalisation of incomes and prices between regions within China or between economies through international trade. Instead it can lead to crises and it is crises that even out the differentials in costs and deliver industries or regions that are 'unviable'. In other words, CAF could generate even more volatility and fluctuations in output and prices unless checked by CAD policy.

The Keynesian investment explanation

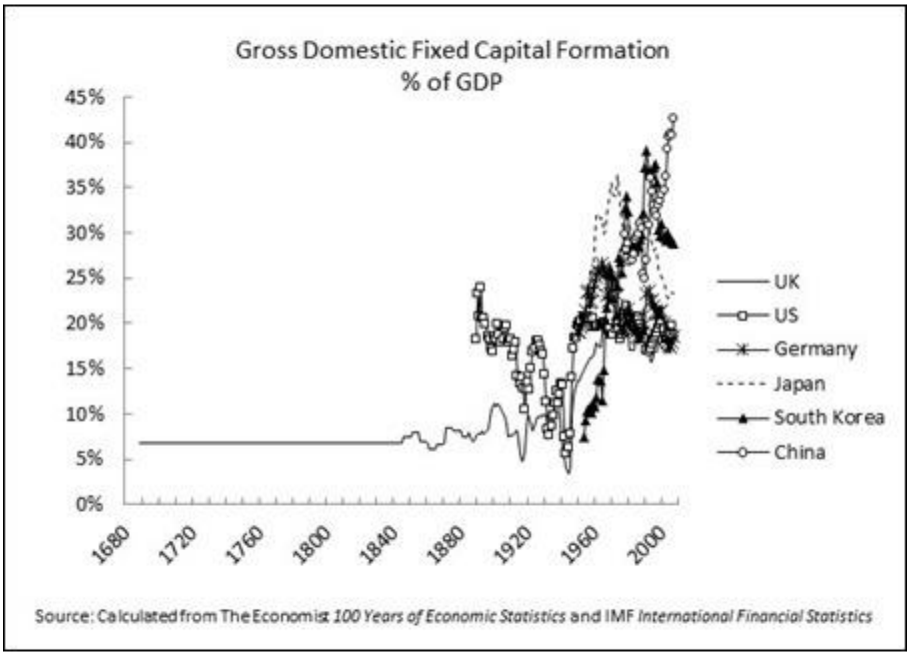
John Ross has proposed a Keynesian explanation to counterpose to the 'balanced development' model outlined by Lin's neoclassical market model.[6] Ross argues that the key factor in China's development was not a switch to a policy of comparative advantage but the continued effort raise investment. For Ross, growth depends fundamentally on an increased division of labour, following Adam Smith's insight[7]. Increased division of labour implies a sustained rise in investment in mechanisation and technology over labour inputs, thus boosting productivity. Thus it was not a switch to using cheap labour and allowing a rise in agricultural prices that allowed China to 'take off' but more investment in technology i.e. greater capital inputs as well as labour.

Ross considers that this how John Maynard Keynes, the macroeconomist of the Great Depression, saw economic development. Keynes' explanation was different to Smith's as Keynes rooted development in rising savings levels accompanying development[8]. As total savings necessarily equals total investment, a rising proportion of saving therefore necessarily means a rising proportion of investment.

Lin follows the neoclassical counterrevolution that denied that it was investment that drove economic growth. Consumption was the driver and scarce resources would be allocated according to consumer preference through the working of market forces.[9] But as Ross shows, the trend in economic development has always been for the proportion of the economy devoted to investment to rise..

Figure 1

[6] Ross
[7] Smith Wealth of Nations
[8] Keynes As the percentage of income consumed fell with increasing wealth, the proportion devoted to saving necessarily rose proportionately: 'men are disposed… to increase their consumption as their income increases, but not by as much as the increase in their income… a higher absolute level of income will tend… to widen the gap between income and consumption.' (Keynes, 1936, p. 36)
[9] Milton Friedman devoted a book, *A Theory of the Consumption Function*, to attempting to refute Keynes on this (Friedman, 1957).



According to Ross, following his interpretation of Keynes, the rising proportion of the economy devoted to investment meant any downturn in the latter would have increasingly destabilising consequences. So it was necessary to revise China's economic policy under Deng to reduce the impact of these destabilising influences. The Deng revolution was not to adopt CAF, as Lin claimed, but to end administrative control (by dictat) of investment and replace it with a Keynesian-style macroeconomic model that would boost investment further.

The Chinese model of development, 'socialism with Chinese characteristics', is in reality a radical version of Keynesianism, according to Ross. It is different to Keynesian policies in the US and Europe where budget deficits have been utilised, low central bank interest rates have been pursued and some forms of quantitative easing, driving down long term interest rates through central bank purchases of debt, have been used. But no serious programmes of state investment have been launched – let alone Keynes's 'socialisation of investment'.[10]

Ross states: "In China, in contrast, relatively limited budget deficits have been combined with low interest rates, a state owned banking system and a huge state investment programme. While the West's economic recovery programme has been timid, China has pursued full blooded policies of the type recognisable from Keynes *General Theory* as well as its own 'socialism with Chinese characteristics.' Ross argues that it Deng's lack of ideology or commitment to either a market or state-led economic mode that has been the reason for China's economic success.[11]

Contrary to Lin's policy prescription, Ross endorses economic measures that involve a large scale state-financed house building programme, or large scale expansion of transport, of the type China followded as part of recent anti-crisis measures. This not only delivers goods that

[10] Keynes

[11] "Because in the US and Europe, of course, it is held that the colour of the cat matters very much. Only the private sector coloured cat is good, the state sector coloured cat is bad. Therefore, even if the private sector cat is catching insufficient mice, that is the economy is in severe recession, the state sector cat must not be used to catch them. In China both cats have been let loose – and therefore far more mice are caught."

are valuable in themselves but boosts the economy through macro-economic effects in raising investment. So whereas in the US, for example, fixed investment fell by over 25% during the financial crisis in China, urban fixed investment rose by over 30%. Consequently, there is no mystery why China's economy grew by 41.4% in the four years since the peak of the last US business cycle at end 2007, while the US economy has grown by only 0.7%!

The Marxist value explanation

The Marxist explanation of China's economic development neither starts from looking at factors of production and comparative advantage nor at the rate of savings or investment in an economy. Marxist theory starts from the law of value. Capitalism is the dominant mode of production globally and has become so precisely in the period of China's take-off since the late 1970s. China's economic development is better gauged from the ability of an economy to avoid the unstable impact of the law of value while also recognising its inexorable power.

On the one hand, attempting to force-fit a competitive model into a real economy can lead to widespread "collateral damage" to development in an emerging economy surrounded by advanced imperialist powers with huge reserves of technology and human capital. The neoclassical prescription for economies that, like China (and the Soviet Union), had restricted the law of value to the barest minimum through central planning, state ownership of industry and collectivisation of agriculture was 'shock therapy'. This solution was imposed in Russia and eastern Europe i.e. a switch from a centrally planned economy, heavily industrialised and nationalised, into a market economy, with foreign investment and privatisation overnight.

Lin opposes this in his policy prescription for China, recognising the need for a 'gradual' switch from CAD to CAF policies, which he considers Deng did. In Marxist terms, this means a gradual expansion of the law of value into the Chinese economy, namely a bigger private sector, the accumulation of capital (investment for profit), prices determined by markets not administrative dictat and finally, the opening up of 'free trade', foreign investment, the ending of capital controls and a floating currency.

This is what Lin and his former employers, the World Bank, regularly advocate for China in the next decade. But if an analysis is based not on the so-called law of comparative advantage, but on Marx's law of value, then an explanation of development recognises that it is not the absence of competition that produces development alongside underdevelopment, wealth alongside poverty, employment alongside unemployment. It is competition itself.

The problem with Lin's explanation is that there is a confusion between the theory of comparative cost advantage and comparative factor advantage.[12] It is one thing to

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[12] See Anwar Shaikh for this key distinction: Comparative factor advantage theory stands on the shoulders of the theory of comparative cost advantage, by seeking to explain which particular industries in a given country will have a comparative cost advantage. The basic answer is that it would be those industries whose production benefited the most from the cheap local input. And the locally cheap input would in turn be explained by the relative abundance of the corresponding "factor of

note that China has or had plentiful supplies of labour and land to develop; it is another to reckon that not investing in technology and heavy industry, but just using light industry and cheap labour can deliver a comparative cost advantage in global markets. Indeed, China's growth differential with average global growth has been achieved not through cheap labour and agricultural 'comparative advantages' but through increased capital inputs, as Ross has argued.

There is a continued contradiction of productive forces here between the expansion of industry and trade on world markets for China using its comparative factor advantages and the pressure of the law of value exerted through trade and foreign investment. The effects of foreign investment have a double content. On the one hand, in the absence of foreign investment, China would have had a structural trade deficit and foreign debt - or an import level restricted to the level supportable by a reduced export sector. So foreign investment is an agency of modernisation from the outside. However, the risk is that large-scale domestic industry would become dominated by foreign capital, side by side with backward industries in which local capital predominates. This might help the trade balance but would accelerates the devastation of local (capitalist and non-capitalist) production and act as a powerful blocking mechanism against the development of the indigenous forces of production[13]. The destruction of native industry would displace more workers than can be newly employed in the relatively new hi-tech industries.

This was the story of many new capitalist economies in the late 19th century onwards as developed by imperialist economies. It remains the story of most of Africa, much of Latin America and parts of Asia with some exceptions. But China remains the glaring exception. Why? Because the law of value operates in free markets, foreign trade and investment. And this was at first totally blocked and later curbed and controlled by a large state-owned sector, central planning and macro policy as well as restricted foreign ownership of new industries and controls on the flow of capital in and out of the country.[14]

As leading Chinese economist Yu Yongding put it: "China has to maintain its capital controls in the foreseeable future. If China were to lose control over its cross-border capital flows it could lead to panic and so capital outflows would turn into an avalanche and eventually bring down the whole financial system."

It was these very restrictions that enabled China to expand investment and technology, employ swathes of labour and generally avoid control of its destiny by multinational combines, up to now. And it is this model that the neoclassical economics, as presented by

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production" (land, labor, capital). Thus if land was relatively abundant in some country, then according to factor advantage theory, land-intensive industries such as agriculture.

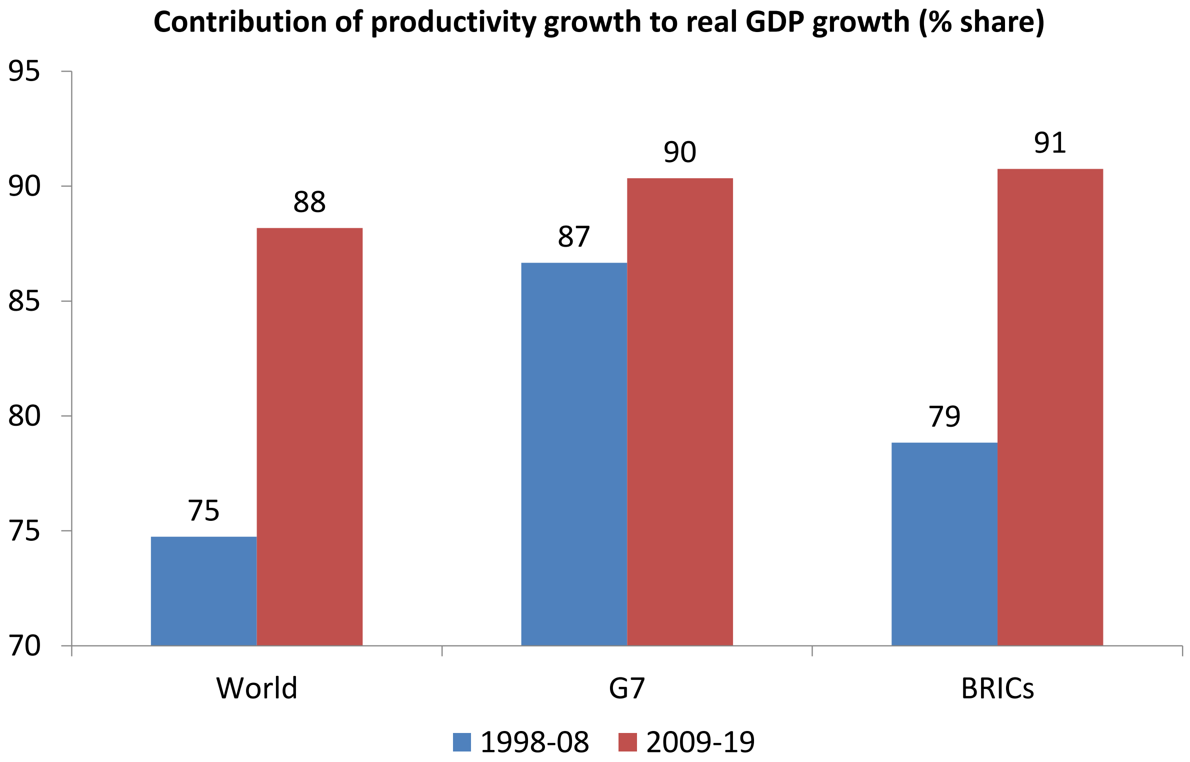
[13] Shaikh

[14] Joseph Stiglitz, Nobel Prize winner in economics, concluded, reviewing the history of financial crises: "Capital account liberalization was the single most important factor leading to the crisis. I have come to this conclusion not just by carefully looking at what happened in the [Asian] region, but by looking at what happened in the almost one hundred other economic crises of the last quarter century… capital account liberalization represents risk without a reward."

Lin wants to end to replace CAD with CAF. The neoclassical model is now advocated for China by most mainstream economists, by many within the Chinese leadership and by outside international agencies.

The Keynesian analysis advocated by Ross looks at savings and investment as the key indicators for China's development. But this misses the Marxist categories. For Marxist theory, it is productivity that is key. Is the productivity of labour rising? And, in so far as there is private sector in a developing economy and world markets, then profitability is the other key indicator.

Overall productivity contributed 75% of world growth in the ten years before the global crash.



In a comparative study of models of economic growth, Vu Minh Khuong[15] looked at productivity growth. Productivity growth can be achieved by, either increased capital and labour inputs, or by innovation and the raising of quality of existing capital and labour. Productivity accruing from 'innovation' is called total factor productivity (TFP) in mainstream economncis.[16]

In a way, which is more important will lead to either neoclassical or Keynesian prescriptions. The Marxist model is that the level of productivity will decide economic growth because it reduces the cost of production through in labour time and enables a developing nation to compete in world markets. But there is a contradiction. There is also the law of profitability. That is in conflict with productivity growth in a capitalist economy and so will result in regular occurrences of crises in production. A developing economy needs to reduce this

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[15] *The Dynamics of Economic Growth*
[16] The formalisation of `growth accounting' was carried out in the 1950s by Nobel Prize winning economist Robert Solow.

outcome of the law of value and profitability to a minimum as crises will mean eventual failure in growth.

This is the real model of development: not one markets and comparative advantage that is 'gradually introduced (Lin) or one of uninterrupted investment whatever ever the economic structure of an economy (Ross). The Keynesian model "ignores Marx's basic concern and measuring stick, surplus labor time. Basically, there is a long-term inverse relationship between productivity and surplus value (as workers can only be squeezed so much before they can no longer work); it is this diminishing factor that Marx highlighted as one of the ultimate contradictions of capitalism. You won't find this kind of analysis by analogy in Keynes. The Chinese cannot have taken this seriously as, they continue to squeeze workers to the maximum, e.g. working 16-18 hours a day 7 days a week, being housed in dormitories, etc., to the extent that workers have responded with mass suicide attempts. I don't think Keynes ever broached this subject in such a way as Marx."[17]

Sure, higher investment is part of the development process. Vu claims that his analysis shows that: "the secret of the Asian growth model lies not in achieving high TFP growth but in sustaining reasonable TFP growth: `Capital accumulation was... the primary driver of Developing Asia's lead over other parts of the world in terms of economic growth.' There were no exceptions in this pattern of successful Asian development: `The pattern of rapid growth driven by intensive capital investment... is consistent over time and robust to different types of economies in terms of size, location... and level of development.'

According to Vu, capital investment inputs accounted for 54% of the growth lead of developing Asian economies over the Western industrialized economies and for 62% of developing Asia's lead over other developing economies. High capital investment was almost twice as important as productivity achieved from innovation (TFP) increases in explaining Asia's growth lead over advanced economies. Indeed, as a country moves towards being an advanced economy, the role played by investment in its growth increases. Taking countries in ascending order of economic development, the percentage of growth due to investment is 50% in non-Asian developing economies, 55% in Asian developing economies and 57% in advanced economies.

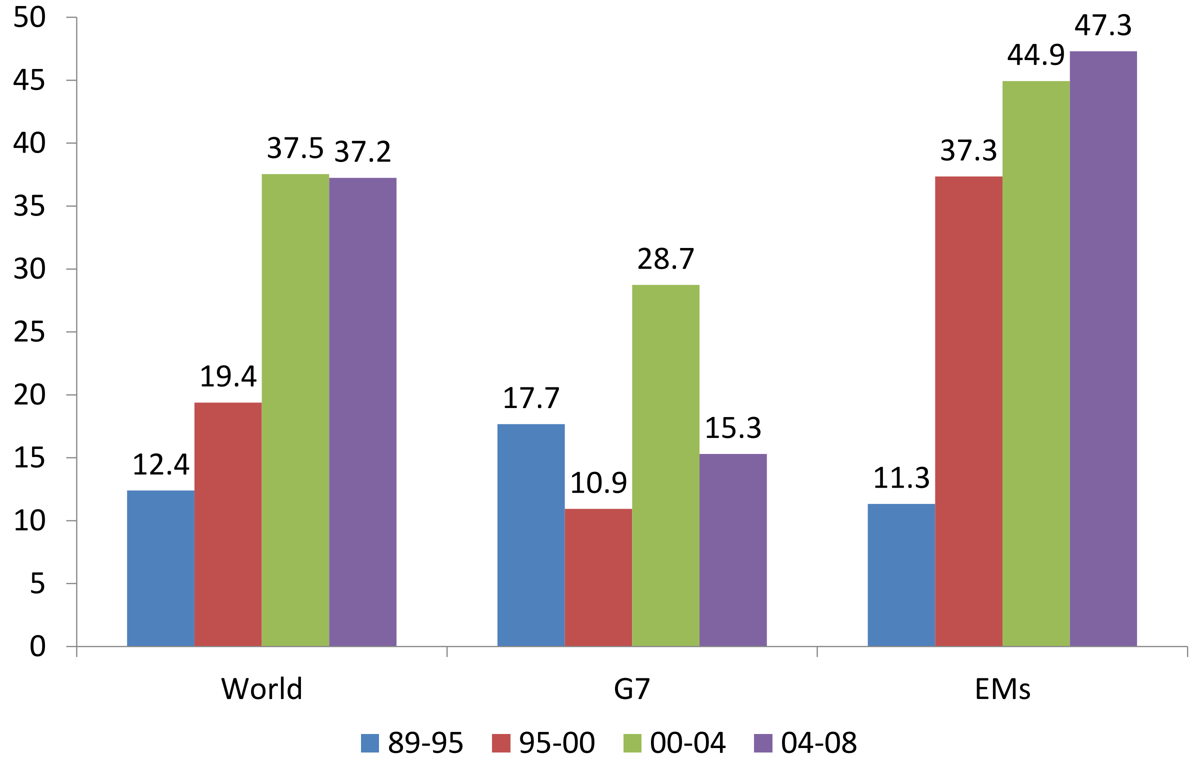
However, there is some doubt that Vu's analysis is correct. In a recent report, the IMF found that higher TFP explained 1.5% points of the 1.75% pts of higher average growth rate in developing economies in the 2000s prior to 2008 compared to the 1990s[18]. TFP growth turned positive in EMs across all regions after declining in both Latin America and the Middle East and North Africa (MENA) region in the 1990s, although factor inputs still remained the main driver of output growth in EMs throughout the 2000s.

Indeed, in analysing an earlier study by Jorgenson and Vu, I found that, within overall productivity growth, TFP has risen in importance compared with labour and capital inputs as a source of world growth over the last 20 years, except in the G7 economies, which have also experienced much slower growth. TFP has risen from a 12% contribution to world GDP growth in the early 1990s to 37% in 2008. But the G7 TFP contribution has fallen from 18% to 15%. The TFP contribution in the

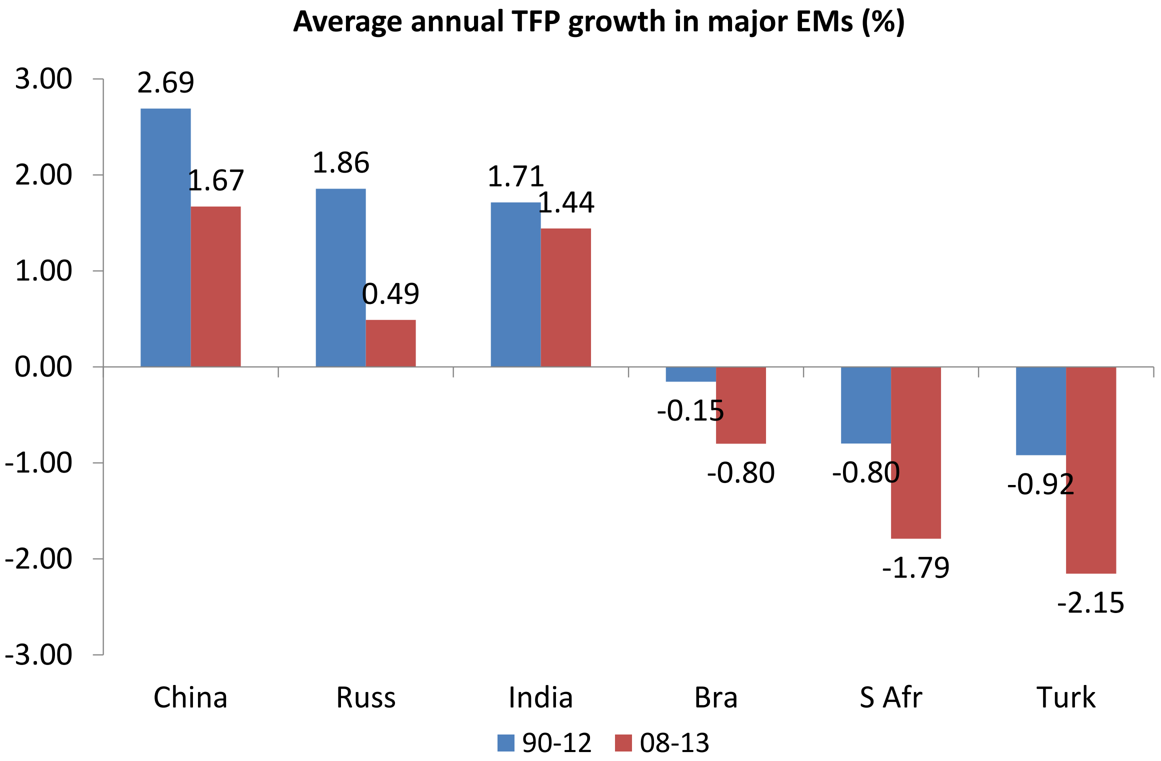
[17] Comment on Ross piece

[18] . IMF staff discussion paper, Anchoring growth: the importance of productivity enhancing reforms in emerging markets, on EMs, December 2013,
http://www.imf.org/external/pubs/ft/sdn/2013/sdn1308.pdf

major EMs has risen from just 11% in the 1990s to 47% in 2008. So innovation and technology transfer was increasingly important to EMs over capital and labour inputs.



Even if China's rapid growth was founded on a very high ratio of capital investment, as well as on cheap labour in the period up to the Great Recession, it may be a different story from hereon. Gross investment has averaged over 47% of GDP since 2009. But real GDP growth has been slowing. So China's productivity return on new investment (or the productivity of capital input) is declining. Back in 2006, before the global crisis, it took 2.9 units of investment to increase real GDP by 1 unit. In 2014, it now takes 6.6 units. China needs to return to its long-term average TFP rate of over 2.5% a year to sustain 7% real GDP growth.



In the Marxist model of capitalist development, productivity growth must be weighed against the contradiction of the tendency of the rate of profit to fall as capital is accumulated. In so far, as China's private capitalist sector expands in its contribution to the overall economy and the public sector is reduced, then the profitability of that sector becomes relatively more important and the contradiction between productivity growth and profitability intensifies. Both the neoclassical and Keynesian models of development ignore this contradiction, namely the contradiction between productivity and the law of value.

The law of value does operate in China, mainly through foreign trade and capital inflows, as well as through domestic markets for goods, services and funds. In so far as it does, profitability becomes relevant to investment and growth.

There have been various attempts to estimate the rate of profit in China[19]. There were three cycles of profitability. Between 1978-90, there was an upswing as capitalist production expanded through the Deng reforms and the opening up of foreign trade. But from 1990 to the end of that decade, there was a decline as over-investment gathered pace and other economies, particularly in the emerging world went through a series of crises (Mexico 1994, Asia 1997-8, Latin America 1998-01). The falling rate of profit then was accompanied by a slowing in the rate of GDP growth. Then from about 1999 onwards, there has been a rise in profitability, which also saw a significant rise in the rate of economic growth (as the world too expanded at a credit-fuelled pace). A more recent study by the Fung Global Institute[20] shows that profit margins in industry rose steadily from 1999 as unit labour costs stayed flat.

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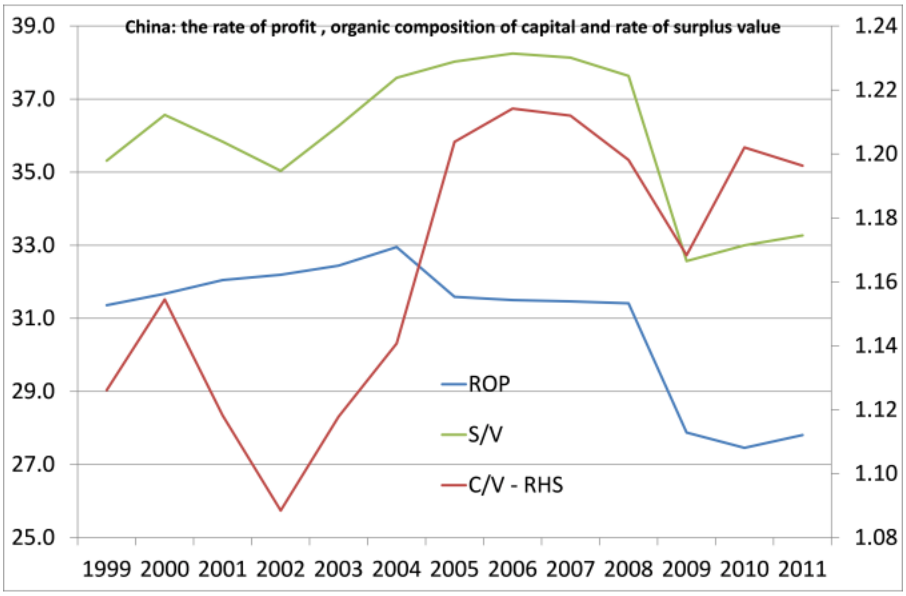
[19] . I did so in my book, *The Great Recession*, chapter 12. There are other studies that reach slightly different conclusions than I did (Zhang Yu and Zhao Feng, 2006, *www.**seruc.com**/bgl/paper%202006/Zhao-Zhang.pdf*; and Mylene Gaulard, 2010, *http://gesd.free.fr/m6gaulard.pdf*). Also see Maito, op cit for confirmation of my own estimates.

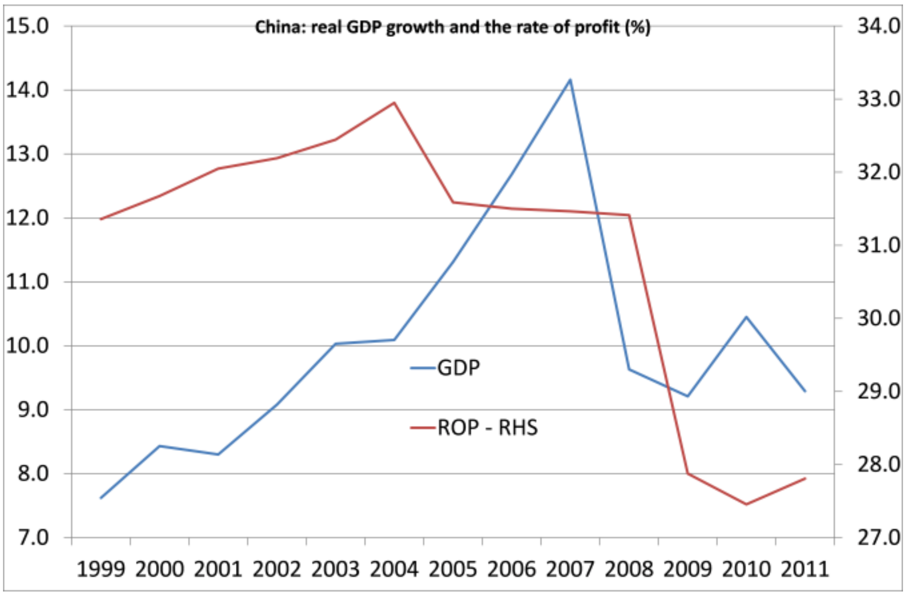
[20] *http://www.fungglobal institute.org)*

We are now getting better data from China to work with. It looks as though profitability peaked in 2004.

After 2007, the slump in world capitalism drove down Chinese profitability. Rising wages were not matched by increased sales abroad, so the rate of surplus value slumped (green line) while investment in fixed capital remained high (red line). So profitability fell.



Inevitably, this has had a deleterious effect on GDP growth, as profits lead investment and investment leads growth, particularly in China.



Thus the law of value in world markets feeds through to the Chinese economy. But the impact is 'distorted', 'curbed' and blocked by bureaucratic 'interference' from the state and the party structure to the point that it cannot yet fully dominate and direct the trajectory of the Chinese economy.

China's "socialism with Chinese characteristics" is a weird beast. It is not 'socialism' by any Marxist definition or by any benchmark of democratic workers control. And there has been a significant expansion of privately-owned companies, both foreign and domestic over the last 30 years, with the establishment of a stock market and other financial institutions. But the vast majority of employment and investment is undertaken by publicly-owned companies or by institutions that are under the direction and control of the Communist party. The biggest part of China's world-beating industry is not foreign-owned multinationals, but Chinese state owned enterprises.[21] The major banks are state-owned and their lending and deposit policies are directed by the government (much to the chagrin of China's central bank and other pro-capitalist elements). There is no free flow of foreign capital into and out of China. Capital controls are imposed and enforced and the currency's value is manipulated to set economic targets (much to the annoyance of the US Congress).

At the same time, the single party state machine infiltrates all levels of industry and activity in China. According to a report by Joseph Fang and others [22]there are party organisations within every corporation that employs more than three communist party members. Each party organisation elects a party secretary. It is the party secretary who is the lynchpin of the alternative management system of each enterprise. This extends party control beyond the SOEs, partly privatised corporations and village or local government-owned enterprises into

[21] A recent report by the US-China Economic and Security Review Commission [21]provides a balanced and objective review: "*The state owned and controlled portion of the Chinese economy is large. Based on reasonable assumptions, it appears that the visible state sector – SOEs and entities directly controlled by SOEs, accounted for more than 40% of China's non-agricultural GDP. If the contributions of indirectly controlled entities, urban collectives and public TVEs are considered, the share of GDP owned and controlled by the state is approximately 50%.*"

[22] (http://www.nber.org/papers/w17687),

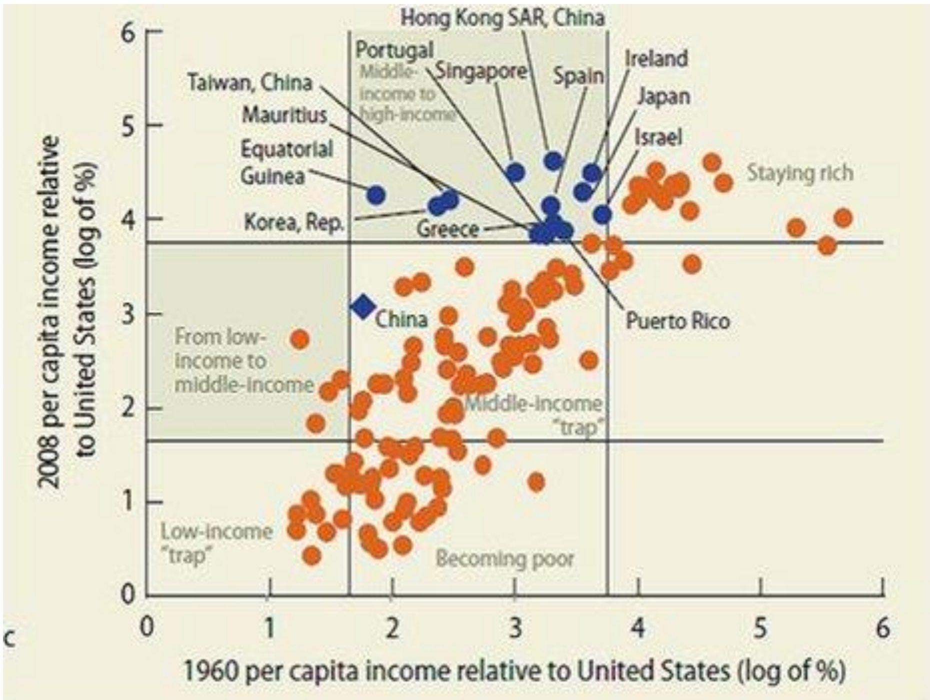
the private sector or "new economic organisations" as these are called. In 1999, only 3% of these had party cells. Now the figure is nearly 13%. [23]

The future of China's development

The argument of this paper that neither the neoclassical nor the Keynesian model of development is accurate or most relevant to understanding China's economic miracle over the last 30 years, let alone since 1949. The Marxist model of rising productivity through investment and innovation to replace labour and the accompanying contradiction with the dominant law of value in the world economy provides the best explanation.

But what of the future? Let us consider what the three models suggest? If Lin and others of the neoclassical CAF school are correct, then China needs drastic restructuring of its economic model. The argument goes that China is now a 'middle-income' (capitalist) economy and unless it allows the market to rule, it will not close the gap in productivity and income per head with the advanced, older capitalist economies.

The argument of the Sinology 'experts' of mainstream economics is that only this will enable China to escape from the so-called 'middle income trap'. They mean that, to begin with, 'emerging economies' can grow fast with big capital investment and exports using cheap labour and new technology – the Chinese model. But less than a fifth of the 180 countries in the world have made it to being advanced economies. Of the 101 countries that were "middle-income" in 1960, only 13 had managed to break from the pack to become advanced economies by 2008.



[23] As the paper puts it: "*The Chinese Communist Party (CCP), by controlling the career advancement of all senior personnel in all regulatory agencies, all state-owned enterprises (SOEs), and virtually all major financial institutions state-owned enterprises (SOEs) and senior Party positions in all but the smallest non-SOE enterprises, retains sole possession of Lenin's Commanding Heights.*"

One reason why countries get stuck in this "middle-income trap" is that they reach what is known as the "Lewis Point", after the left economist of the 1950s, Arthur Lewis. Put simply, this is the point at which a developing country stops being able to achieve rapid growth relatively easily, by simply taking rural workers doing unproductive farm labour and putting them to work in factories and cities instead. But once this 'reserve army of labour' is exhausted, urban wages rise, incomes reach a certain level and a 'middle-class' emerges. Distorting Lewis' theory, mainstream economics asserts that then there must be a switch to boosting domestic consumption that a state-led economy cannot do. So the cry is "liberalise with free trade and capital – that's the only way to move on". [24]

The neoclassical model was advocated for China's future in a World Bank report taking up Lin's theses and [25]published in conjunction with China's advisory body, the Development Research Center of China's State Council. The report argued that there would be an economic crisis in China unless state-run firms were scaled back. China needed to implement 'deep reforms', selling off state-owned enterprises and/or making them operate more like commercial firms. According to the World Bank, China's growth would decelerate rapidly once people reached a certain income level, a phenomenon that these economists call the "middle-income trap." The report said the answer to set up 'asset-management firms' to sell off state industries, overhaul local government finances and promote 'competition and entrepreneurship'. The first of its six strategic measures is the privatisation of the state. This is put right up front. In contrast, there is no mention of the democratisation of the state, the ending of one-party rule; the ending of the suppression of individual rights and freedoms, allowing trade union rights etc.

But is this scenario of the 'middle-income' trap due to the loss of 'comparative advantage' in cheap labour, Lewis-point style? Or is it due to the failure of developing capitalist economies to raise productivity and sustain investment in technology and human capital in the face of cycles of falling profitability and global crises, often engendered in the mature capitalist economies and thus outside the control of individual national economies?

It is no accident that only two large developing capitalist economies have succeeded in becoming part of the rich capitalist club in the last 50 years[26]. Measured in GDP per capita and starting at $3000 per head (PPP real) 40 years ago, Taiwan and Korea now have per capita GDPs over $25,000. In the same period, no other Asian tiger or Latin American economy has risen above $13,000, still within the World Bank's middle income range.

Taiwan was a special client state of the US and also benefited hugely from China's own expansion and from Japan trade. Korea also had a special trade agreement with US. Both economies had large state holding companies, military regimes that restricted 'free markets' and were oriented to investment in heavy industry and technology – not the neoclassical model. Interestingly, at its current stage in this process, China's per capita GDP is higher and growing much faster than even Taiwan and Korea.

The World Bank report admits that the capitalist mode of production still does not dominate in China – indeed that is the problem according to the World Bank and its domestic

[24] Typical of these arguments are the comments of James McGregor[24]. He commented "*China's done well in building infrastructure and getting the nation where it is but state industry is choking off economic growth so they have to re-ignite private industry.*"
[25] (*China 2030; http://www.worldbank.org/en/news/2012/02/27/china-2030-executive-summary*),
[26] Excluding Hong Kong and Singapore as tiny city states

supporters. The report recognises that China's incredible economic success over the last 30 years was based on an economy where growth was achieved through bureaucratic state planning and government control of investment. China has raised 620 million people out of internationally defined poverty. Its rate of economic growth may have been matched by emerging capitalist economies for a while back in the 19th century when they were 'taking off'. But no country has ever grown so fast and been so large (with 22% of the world's population) – only India, with 16% of the world's people, is close. As John Ross has pointed out[27], in 2010, 87 countries had a higher per capita GDP than China, but 83 were lower. Back in the early 1980s, three-quarters of the world's people were better off than the average Chinese. Now only 31% are. This is an achievement without precedent.

Even if China slows down over the medium term, as the World Bank predicts, it will still add over $21trn to its GDP before the end of the decade and reach the size of the US economy by then. Even though China's consumption as a share of GDP is very low by capitalist standards (anywhere between 35-45% of GDP, depending on how you measure it, compared to 65-75% in mature capitalist economies), it will add another $10trn in annual consumption by 2020, equivalent to the size of America's annual consumption. These figures come from the World Bank report itself. This has been achieved without the capitalist mode of production being dominant.

Nevertheless, the neoclassical school continues to promote a development model for China that is 'consumption-led' and dominated by markets. Apart from Lin and the World Bank, other variants include the China watch economists like Michael Pettis and Nicholas Lardy.

Pettis' argument is that China has been through four stages of growth, each dependent on allowing incentives for individuals to make money[28]. There was the Deng era that allowed small businesses to fill the shortage gaps created by inefficient large state firms. Then came the period of the 1990s, with a massive expansion of infrastructure that by necessity had to be undertaken by central and regional government. But this gave way to a contradiction between growth through investment and the need to develop sophisticated financial channels boost the private sector and household consumption. Investment growth became too great. What is needed now, according to Pettis, is a new liberalising period that "must include changing the legal structure, predictably enforcing business law, changing the way capital is priced and allocated, and other factors that determined the incentives, so that Chinese are more heavily rewarded for activity that increases productivity and penalized, or at least less heavily rewarded, for rent seeking."

According to Pettis, this is what is behind most of the reforms proposed during the Third Plenum and championed by President Xi Jinping and Premier Li Keqiang. In nearly every case – land reform, hukou reform, environmental repair, interest rate liberalization, governance reform in the process of allocating capital, market pricing and elimination of subsidies, privatization, etc – these reforms effectively transfer wealth from the state and the elites to the household sector and to small and medium enterprises. Without these reforms, China will continue to be overheavy in savings, debt and investment and underweight in productivity, consumption and growth.

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[27] out (*http://ablog.typepad.com/keytrendsinglobalisation/2012/02/chinas-achievement.html*)
[28] Pettis

Nicholas Lardy presents similar arguments, except for Lardy the private sector was the cause of China's success anyway, denying any role for the state or central planning. Now all that needs to be done is to reduce yet further the role of the state companies in business services, as well as in upstream oil and gas to boost productivity and profitability. For Lardy, the two are not contradictory but complementary. "If China enacts economic reforms announced last year, particularly eliminating all but natural monopolies such as power distribution, and making the market the decisive factor in the allocation of resources, private businesses will displace state enterprises in services. That would allow China to sustain a relatively high rate of growth and thus to continue its role as a leading driver of global growth."[29]

The neoclassical model remains full of holes. It is not really true that the Chinese economy has restricted consumption. Consumption may have fallen as a share of GDP during the fast pace of investment expansion and urbanisation, but real consumption per head in China has been growing at 8.5 per cent annually for a decade — the highest of any major economy. What has happened with the 'liberalisation' of the economy, the expansion of the private sector and the encroachment of the law of value into new areas of the economy is a huge rise in the inequality of wealth and income.

China's gini coefficient, an index of income inequality, according to Sun Liping, a professor at Beijing's Tsinghua University, has risen from 0.30 in 1978 when the Communist Party began to open the economy to market force 0.46. Indeed, China's Gini coefficient has risen more than any other Asian economy in the last two decades. If the law of value becomes dominant, it will expose the Chinese people to chronic economic instability (booms and slumps), insecurity of employment and income and greater inequalities.

But the Keynesian model for China's future is also flawed. The Keynesian model calls for higher savings and investment. But this ignores the role of profitability. If the state sector is reduced further, the largest contributor to savings must come from companies and this will require increasing company profitability in the private sector.

The debate within the leadership will continue about which way to take China: towards a full market economy open to the winds of global capital flows or to stay as they are. The view of the media and 'experts' in the West seems to be that the new seven-man standing committee is broadly in favour of the status quo: 'don't rock the boat. If it works, don't fix it'. However, China's new leader, Xi , supports an acceleration of 'economic reforms', namely the new growth model presented in the "China 2030" project with the Chinese State Council and the World Bank.

The Chinese Communist party's Third Plenum [30]discussed what to do about China over the next five to ten years[31]. The third plenum did not really commit to anything like 'free market' capitalism. At best, it agreed to a few limited steps towards the development of market forces in banking (more competition for the state-owned banks) and in agriculture (some commercial property transactions), vague talk about 'liberalisation' of capital controls

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[29] Lardy

[30] (*http://wiki.china.org.cn/wiki/index.php/Third_Plenum*)

[31] (*http://chinacopyrightandmedia.wordpress.com/2013/11/15/ccp-central-committee-resolution-concerning-some-major-issues-in-comprehensively-deepening-reform/*).

and currency trading down the road; a few more ‘free trade zones’ for foreign companies to ply their trade; and allowing foreign companies to operate in more service sectors. And of course, there is going to be a very limited relaxation of the terrible one-child policy for families (‘only-child’ parents can now have more than one child) and the control of the movement from rural areas of people into the cities (hukou) by allowing more fee movement into smaller cities.

There was no change in the general philosophy of ‘socialism with Chinese characteristics’ and thus the maintenance of the dominance of the state sector. The other clear message was that there would be no move towards ‘democracy’ or control of even local legal systems and decisions by the people. On the contrary, the leadership is setting up even more repressive state security services to monitor and control the population and curb any dissidence.

Can the elite continue with this ‘halfway house’ without provoking either a crisis or slump that will force them to follow the ‘capitalist road’ (the neoclassical model that the World Bank and the pro-capitalist elements want)? Can China really sustain a Keynesian-style model of high investment without innovation? Or will the contradictions between socialism with Chinese characteristics and the law of value in a global capitalist world intensify? Indeed, will the elite face an eruption from below as the fast-growing working class urban population takes things into their own hands?

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