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State Capacity and the Sustainability of China's Economic Growth

Abstract

There has been growing concern over the sustainability of China's economic growth. The Chinese economy is excessively dependent on investment and exports, a pattern that has become increasingly unsustainable. The excessive dependence on investment and exports results from insufficient household consumption, which, in turn, reflects rising income inequality and inadequate provision of social welfare. The underlying cause has to do with the weakening of China's state capacity. Nevertheless, China's state capacity remains relatively strong and a strengthening of the state capacity will contribute to a more sustainable pattern of economic growth.

Key words (up to six)
Chinese Economy; State Capacity; Economic Growth; Sustainability

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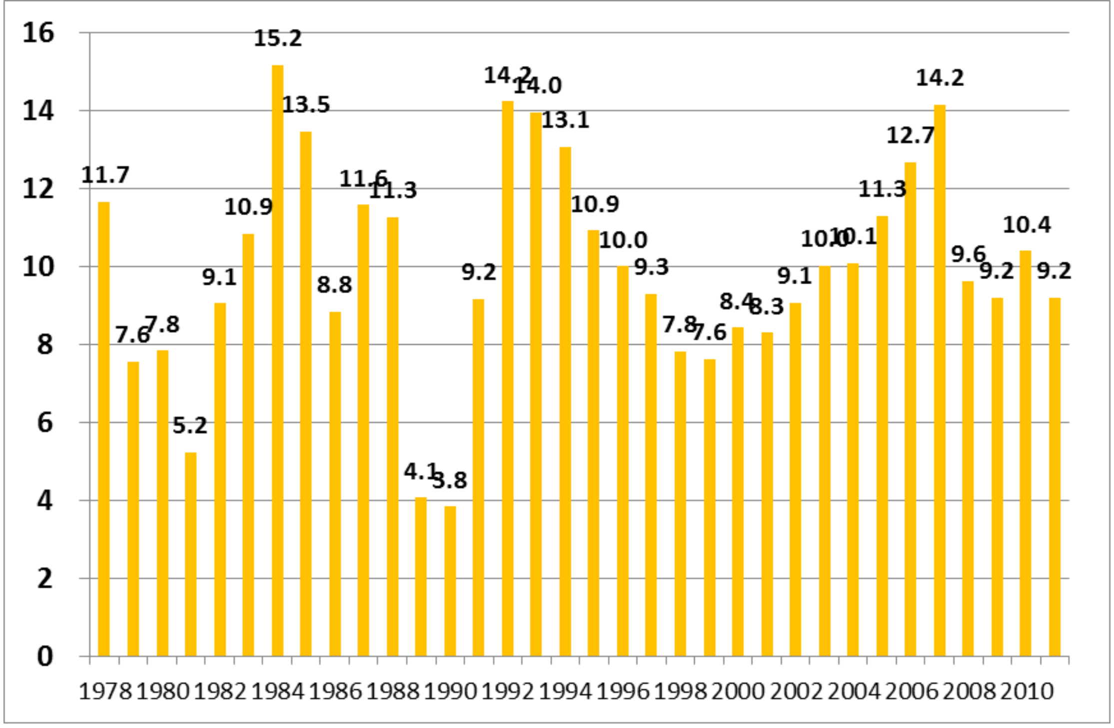
In recent months, the Chinese economy appears to have slowed down and some observers raise the concern that the Chinese economy could suffer from a hard-landing in the near future.It is true that many contradictions and tensions could threaten China's economic growth. On the other hand, since the 1980s, despite many criticism of China's strategy of economic growth and transition, China has been able to sustain rapid economic growth for about three decades. From 1978 to 2011, the Chinese economy grew at an average annual rate of 10 percent, while the world economy grew at 2.9 percent over the same period. (See Figure 1)

Figure 1 Growth Rate of China's Gross Domestic Product (percent):1978-2011



Source: China Statistical Yearbook 2011 and National Statistical Bureau of China website (for 2011)

While some criticisms of the Chinese economy are based on ideologically biased theories, such as neoliberalism, others have made the valid point that certain trends of the Chinese economy are unsustainable. But the weakness of these studies is that they fail to take into account the importance of the state capacity.

A lot of scholars, mostly political scientists, rather than economists, studied state capacity from various perspectives. It is understandable that not many economists study the state capacity. The most important reason is that in the past 3 decades, neoliberalism has dominated the economics discipline and mass media. And according to neoliberalism, state intervention is bad for the economy. The smaller is the government, the better the economy would be. With the exception of national defence and justice enforcement, the state should let the market system operate by itself and it would produce the best possible results. However, the reality does not support this theory. The frequent economic and financial crises that have happened over the past 3 decades, especially the 2008 world financial and economic crisis, have led more and more people to question the validity of neoliberal theory. Maybe it is the time to introduce the term of state capacity into economics.

In this paper, we will try to analyse the change of the state capacity and its impacts on economic growth in China. In next section, we are going to discuss the definition and measure of state capacity in the Chinese context. Section 2 describes the unsustainable trends in the Chinese economy. Then, we will analyse the change of China's state capacity in the past 3 decades. In section 4, we will conclude by discussing how to strengthen China's state capacity to improve the sustainability of China's economic growth.

1 THE DEFINITION AND MEASURE OF STATE CAPACITY

Just as the leading Chinese political scientist, Wang Shaoguang (1991), pointed out 20 years ago, "it is a literature that badly needs integration and synthesis."Scholars have more or less similar definitions of state capacity. For example, Skocpol(1985)define it as the ability of a government to administer its territory effectively, while Price-Smith (2001) refer to "… one country's ability to maximize its prosperity and stability, to exert *de facto* and *de jure* control over its territory, to protect its population from predation, and to adapt to diverse crises". Understandably, they include more or less the same components into state capacity. Table 1 summarizes 6 representative scholars' definition. These definitions have some common components, such as extractive capacity, i.e. the capacity to mobilize financial resources from the society to pursue the national interest, which is regarded as the most important capacity by many analysts. Of course, all these capacities listed in the table may be important for a nation's development, and they are usually interconnected. For example, the state military/defence capacity is important for the nation's political independence, without it, meaningful development would be impossible. At the same time, strong economic capacity can help to achieve rapid economic growth and provide more resources for the development of defence capacity. This is also true for the relationship between state political and economic capacity. In this paper, we confine our discussions to those elements that directly impact on economic growth, namely, the state economic capacity.

Table 1 Components of State Capacity Defined by 6 Different Scholars

	Components of State Capacity

Skocpol (1985)	sovereign integrity, stable administrative-military control, loyal and skilled officials, financial resources, and authority and organizational means to deploy its financial resources
Migdal (1988)	penetrate society, regulate social relationships, and extract and appropriate resources
Wang(1995)	extractive capacity, steering capacity, legitimation capacity, coercive capacity
Brautigam (1996)	regulatory, administrative, technical, and extractive capabilities
Englebert (2000)	to design and implement policies to spur economic growth and provide good governance, markets, and efficient and accountable institutions
Price-Smith (2001)	human capital, instrumental rationality, coherence, resilience, autonomy, fiscal resources, reach and responsiveness, and legitimacy

In this paper, I define state economic capacity as the capacity of the state in managing the economy to maximize its economic prosperity and stability. It includes agenda setting capacity, extractive capacity, economic management capacity, etc. I will emphasize the indicators of government revenue and public share in banking and investment, because they are among the most important factors of the state to manage the economic and deal with inside and outside shocks.

2 THE UNSUSTAINABLE TRENDS IN THE CHINESE ECONOMY AND THE STATE CAPACITY

It is widely accepted that there are several unsustainable trends in the Chinese economy. For example, Li (2002) emphasizes the unsustainability of the massive use of energy in the Chinese economy, and Zhu and Kotz (2011) emphasize the overdependence of the Chinese economy on investment and export.In this section, I will discuss several important and related unsustainable trends in the Chinese economy.

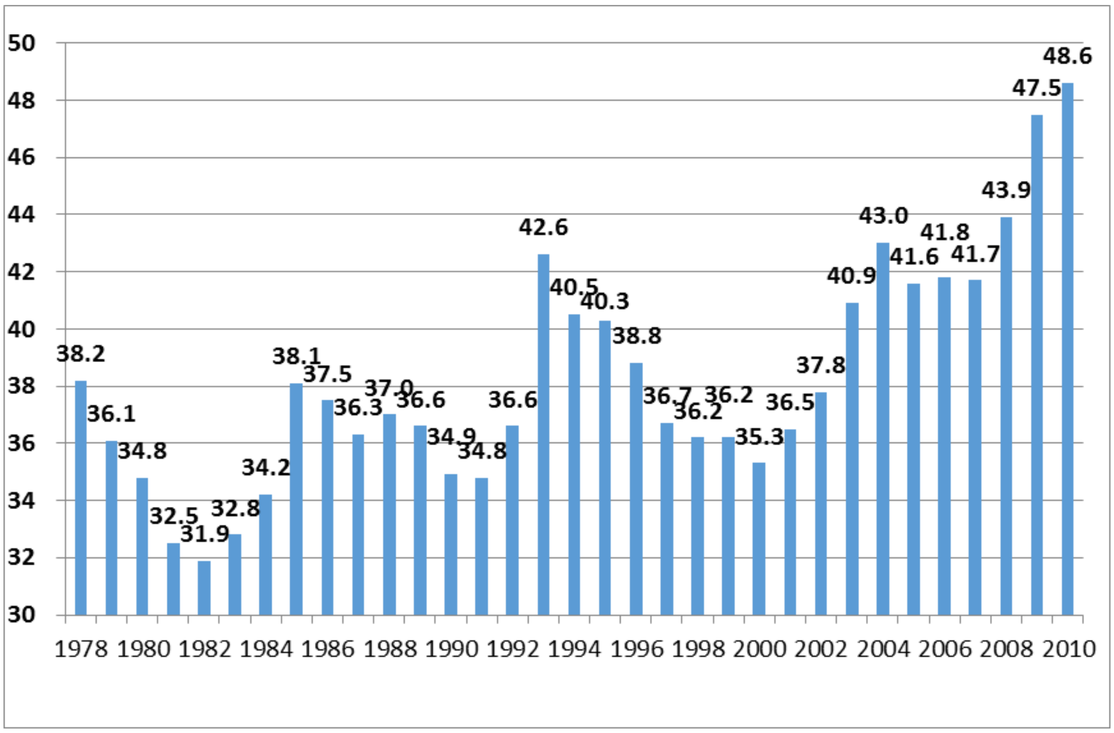
First, the rapid pace of growth of China's exports and net exports cannot be sustained. In 1978, China exported only $9.7 billion of goods and services and net exports was negative. In 1980s, it has modest exports growth, averaged at about 3percent per year, while in 1990s, exports increased very fast, at an annual growth rate of about 16percent. As a result, the total exports of China in 2000 were $249.2 billion, almost 25 times of 1978 level. And net exports were $24.1 billion in the same year. After it joined into the World Trade Organization (WTO), China's exports increased even faster, at about 19percent per year, between 2001 and 2010. If we only look at the pre-crisis years, between 2001 and 2007, the annual growth rate was about 23percent. In 2007 and 2010, China's exports were $1.2 and $1.6 trillion, respectively. And the net exports were $264 billion and $182 billion in the two years.

Rapid exports and net exports positively contributed to the rapid economic growth in China. Between 2001 and 2007, on average, net exports contributed 10percent of China's GDP growth, and in 2005, almost one fourth of China's economic growth derived from net exports. However, it also brings about at least two problems to China. One is that China's international trade dependence ratio (measured as the ratio of total international trade to GDP) is too high. In 2007, it reached 70percent, which means the Chinese economy severely exposed to the risks of the international market. As a big country, this would be quite dangerous, just as what happened during the 2008 crisis. The other is the rest of the world cannot tolerate such a rapid growth rate of exports from China in the future any more. In 2010, China was already the biggest exporter in the world, with10.3 percent of world total exports. Economically, as world economy grows at a pace of about 3 percent a year and faces considerable downside risks in the coming years, the rest of the world may not be able to absorb rapid expansions of Chinese imports at an annual rate of 20 percent for much longer. Politically, though China rapidly transformed into a market economy, there are many important economic and political differences between China and the developed countries dominated the world economy for a long time. They may not quietly allow China's exports to grow at such a fast speed, especially when they are facing so many economic and political difficulties.

Together, these two problems exert a lot of pressure on China. China's exports growth is likely to slow down significantly and China will have to rely more on domestic demand. This brings us to the second unsustainable trend, the high and rising investment ratio.

Second, the high and rising investment ratio in China cannot be sustained in the future. As a developing country, China needs to invest a lot to improve its industrial base and infrastructure. This can partially explain the rapid growth of China's investment, at 11.6percent per year between 1978 and 2010. It contributed more than 39percent of China's GDP growth during the same period. However, now the investment level maybe too high in China. Or, in other words, China's economic growth may rely on investment too much. Figure 2 shows the investment ratio in China in the reform and opening up period. From it, we can see, China has high level of investment ratio in the whole period, always higher than 30percent. However, in recent years, it reached an exceptional high level. Before 2003, there are only 3 years (the investment boom in 1993-1995) in which the ratio is higher than 40percent. After 2003, investment is always higher than 40percent, with the highest level of 48.6percent in 2010. According to Ma Jiantang, Commissioner of the National Bureau of Statistics of China, in 2011, China's GDP increased 9.2 percent, but the investment in fixed assets increased by 16.1percent. Therefore, the ratio in 2011 must be even higher. This trend cannot last very long in the future. In the short run, high level of investment is good for GDP growth. But investment also means the increase of production capacity for the future. Though a lot of investment in China was in the infrastructure, a big part of investment does go into the creation of new factories and equipment and increase industrial capacity. With such a high level of investment, China suffers more and more from overcapacity in many industrial sectors. For instance, according to a 2011 report issued by China's Ministry of Industry and Information Technology, excessive capacity is an outstanding problem in many sectors, such as the heavy and chemical industries. It plans to eliminate a lot of industrial capacity by 2015, including 70 million tons of iron and six million tons of iron alloy.High level of excess capacity usually brings low levels of profit rate, which means less financial resource to invest, ceteris paribus. It also exerts high pressure on the firms to find new market for its product. However, as discussed above, international market may not be a good solution. The only way left is to increase domestic investment and/or consumption. But increasing investment can only solve the problem in the short run and will worsen the overcapacity problem. Domestic consumption will be the last hope.

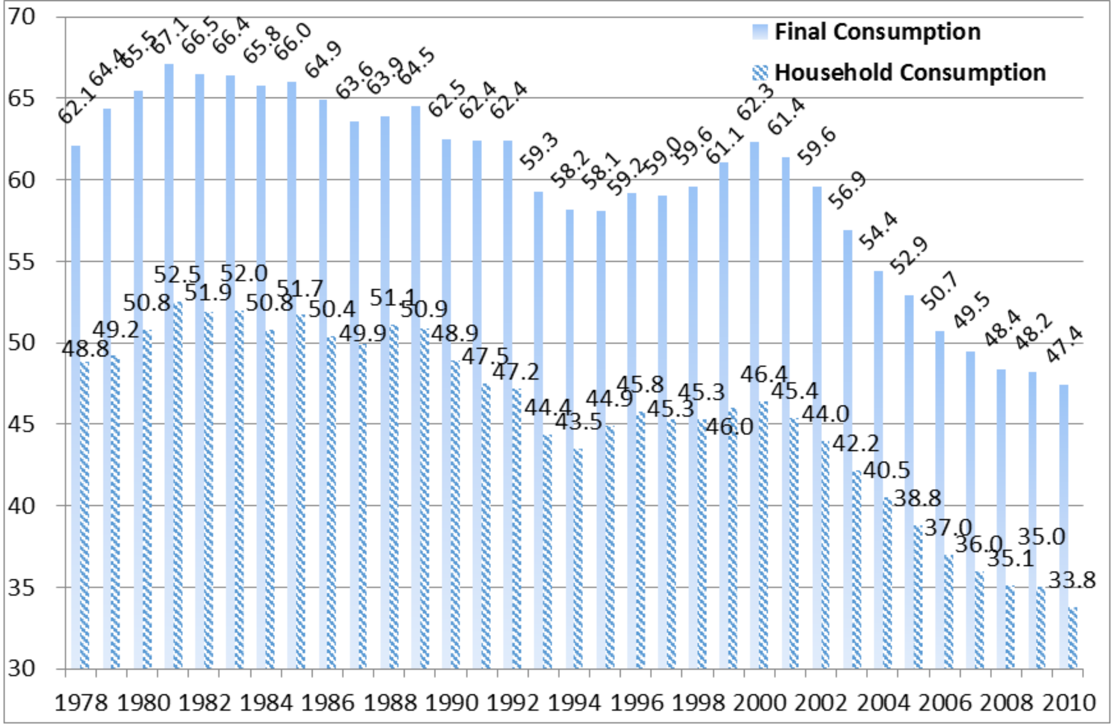
Figure 2.Investment in China (as percent of GDP): 1978-2010



Source: China Statistical Yearbook 2009 and 2011

Third, the household consumption ratio should not stay at the current low level. By expenditure approach, GDP is composed of final consumption (the sum of government consumption and household consumption), gross investment, and net exports. Since the last two components cannot sustain their current trends, the first cannot either. In fact, it was because the final consumption, especially the household consumption, did exert a drag on the Chinese economic growth, the Chinese government adopted policies to encourage exports and investment. Figure 3 shows the household and final consumption ratio in china in the past 3 decades. It is easy to tell that except for several years, the consumption ratio in China has been decreasing between 1978 and 2010. In this period, the government consumption more or less keep pace with the economic growth, therefore its share in GDP is relatively stable. The decrease of final consumption ratio is mainly caused by the slow growth of household consumption relative to the GDP growth. The household consumption ratio decreased from 48.8 percent in 1978 to 33.8 percent in 2010.

Figure 3. Consumption in China (as percent of GDP): 1978-2010



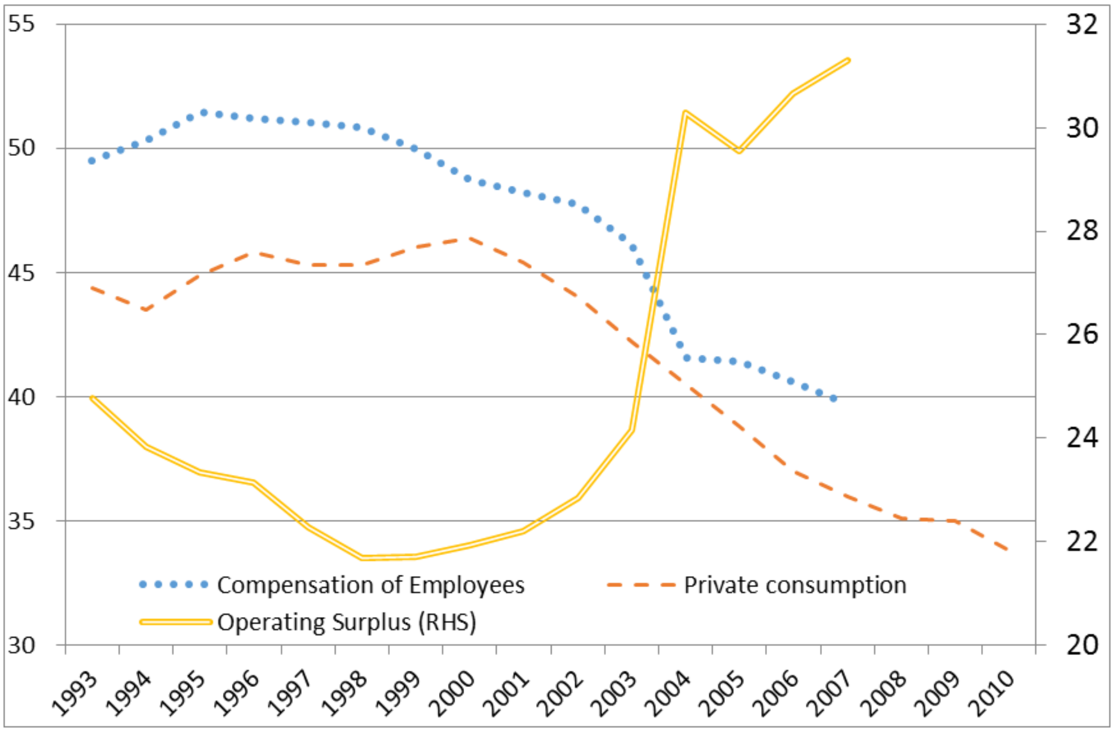
Source: China Statistical Yearbook 2009 and 2011

In one word, the current growth model of China is unsustainable. The household consumption ratio is abnormally low. Among the 175 countries with available data, China ranks the 173th. The world average ratio is 62percent and that of the United States is 72 percent in 2009. At the same time, China's investment ratio is abnormally high. Among the 177 countries with data, China ranks the 4th. The world average fixed asset investment ratio is 20 percent in 2009, while for China, 46percent. In order to shift the Chinese growth model to a sustainable one with reasonable dependency on export and investment, the consumption ratio, especially the household consumption ratio, must be increased significantly. Furthermore, the most effective way to increase household consumption ratio is to promote the consumption of low and middle class household. The upper class is consuming a lot. As widely observed, the rich Chinese people are purchasing a lot of luxury goods and China becomes the most rapidly growing market for those commodities in the world. According to a recent market report, "China will account for about 20 percent, or 180 billion renminbi ($27 billion), of global luxury sales in 2015. …Even during the global recession in 2009, sales of luxury goods in the mainland rose by 16 percent,…far better than the performance of many other major luxury markets." But comparing with the total household consumption of more than RMB 10 trillion, RMB 180 billion of luxury goods market is too tiny to have an meaningful impact on the macro economy. It is a common sense that richer people have lower propensity to consume than poorer people. Therefore, the income and consumption of the low and middle class must be significantly increased.

For these households, there are two financial resources for consumption, income and loan. However, in China, due to the underdevelopment of consumer credit system, most of the poor people don't have access to consumer loans. Furthermore, today's loan has to be paid back with tomorrow's income. If not, there would be a big trouble, both for the banks and the debtor, just as what we saw in the 2008 crisis in the developed countries. These households usually do not have much capital income and have to rely on labour income to support their expenditure. This brings us to another unsustainable trend in the Chinese economy.

Fourth, low labour income in China is not sustainable. In the past 3 decades, low wage and relatively well-educated labour was an important character of the Chinese economy and helped China to become the biggest exporter and the second biggest economy. But low labour income for most of the employees also means their effective demand is relatively low. Figure 4 shows the share of labour income, capital's profit and household consumption in China's GDP between 1993 and 2010. It is easy to see that the labour share has been decreasing since mid-1990s and correspondingly the profit share has been rising after 1998, especially in early 2000s. Understandably, the consumption ratio is always lower than the labour share and follows the trend of the latter. Therefore, if China plans to increase consumption ratio, it has to raise its labour share by rapidly increase wages. Besides, some scholars began to insist that China is going through the Lewisian turning point, i.e., given the social-economic context, without higher wages in the industry/city, labour will not leave the agriculture/rural area. This argument is based on the shortage of migrant workers in the coast area and its spreading to inland area in China in recent years. At the same time, wages of migrant workers increased rapidly.

Figure 4. Labour Income, Profit and Household Consumption in China (% of GDP):1993-2010



Source: Data of Gross Domestic Product of China, 1952-2004, and China Statistical Yearbook, various years

Admittedly, there are other unsustainable trends in the Chinese economy, such as rising income inequality, environmental degradation, etc. What make things even worse is that almost all of these trends are interconnected and if the state fail to solve any one of them, the consequence could be disastrous. Fortunately, though eroded in the past 3 decades, China's state capacity is still relatively strong and it is still possible for the state to control and reverse those trends.

3 THE EVOLUTION OF CHINA'S STATE CAPACITY OVER THE PAST 3 DECADES

Like many other things, state capacity evolves with the social and economic development of a nation. Over the past 3 decades, China's state capacity evolved with the transition from a central planning economy to a socialist market economy. At the beginning, on behalf of the people, the state controlled most of the economic resources and had very strong economic capacity. With the transition to a market economy, the private sector, including foreign companies, controls more and more economic resources. As a result, the state capacity of China was weakened and a lot of problems emerged. Facing the serious consequences, the central government reversed some of those trends and began to strengthen the state capacity. Now, though eroded, China's state capacity is still strong enough to handle the problems in the short run.

In this section, we will discuss the evolution of several important aspects of China's state economic capacity, including agenda setting capacity, extractive capacity and economic management capacity.

First, agenda setting capacity is one of the most important state capacities. The state should correctly comprehend the situation, wisely design proper policies and effectively implement them. There are two prerequisites for it. First, the state cannot be taken over by the domestic elites or foreign interest groups. It should put the whole society's interest as its priority, rather than only care about some interest groups and only pay oral service to the public interest. Second, the ideas and theory the state adopted should not be wrong. Just as Keynes concluded in his *General Theory*, "...the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.... But, soon or late, it is ideas,...which are dangerous for good or evil."We are still witnessing the disastrous consequences neoliberalism bringing to the world. These two conditions are, to some extent, related. Some interest groups prefer some ideas and theory. For instance, financiers prefer neoliberalism. However, even if the state is autonomous, if it adopted wrong theories to developed policies, the results could be very negative.

In 1980s, foreign and private capital only accounted for a small portion of the Chinese economy and they are unorganized. Therefore, the state of China was quite autonomous. It only adopted those policies that were conceived to be good for economic development. Though western economic model is quite attractive to the Chinese leaders, and some scholars, including Milton Friedman, tried to convince them to adopt neoliberal policies, they are cautious towards those advices. In economics academia, neoliberalism began to win some supporters, but within the state, most officials were sceptical on it. In fact, in this period, the state was quite pragmatic. On one hand, private firms, including foreign firms, are allowed to be established, and price control over some commodities' is lifted gradually. One the other hand, when the reform brought serious problems to the economy, for instance, in 1988, price liberalization caused high inflation, the state slowed down the reform process. However, in this period, private (including foreign) enterprises had developed and had become a pro-market force in the Chinese society.

In the 1990s, especially after 1992, when the state declared that the reform target is to establish a socialist market economy, private and foreign firms were encouraged to develop and neoliberalism did exert some influence on the state. Not only the market system became the basic mechanism of resource allocation, but also a lot of state and collective-owned enterprises were privatized. It was in this period when the state capacity of China was eroded a lot. On one hand, private (including foreign) firms' share in gross fixed assets investment increased from 22 per cent in 1990 to 29 per cent in 1995 and 35 per cent in 2000. They became an important social force to push for more market-oriented reforms. The state has to put their interest on the agenda. Besides, corruption became a serious issue in this period and policy design and implementation was more or less impacted. On the other hand, with more neoliberal economics works and scholars were introduced into China and more and more Chinese economist trained in the west came back to China, neoliberalism began to dominate the economics academia and heavily influence the society through the mass media. As a result, more and more officials accepted the neoliberal ideas and neoliberalism had some impacts on the reform policies. For example, the education and healthcare system was commercialized, millions of public employees were laid off, and most public enterprises were privatized in late 1990s and the after. However, we cannot draw the conclusion that neoliberalism dominated the Chinese government in this period. Keeping the economy growing and the society stable is on top of the agenda. Facing the decreasing share of government revenue in GDP, central government's share in total government revenue, and the related problems, such as many teachers cannot get their pay because the government don't have enough revenue, the Chinese government implemented a tax reform in 1994 and basically solved these problems. This is the first and an important step to strengthen the state economic capacity in the reform era. One more example, in 1997, the Chinese government announced the goal of achieving capital account convertibility by the year 2000. Soon after that, the East Asian financial crisis erupted, and then the issue was not even mentioned by the government again for more than 10 years.

In one word, in the 1990s, the agenda setting capacity of China's state was seriously eroded but the bottom line was still kept.

In the 2000s, with more state owned enterprises privatized and rapid development of private enterprises, the private capital, especially foreign capital, became very strong in China. Since 2006, they have accounted for around two-thirds of China's gross fixed assets investment. Therefore, they have important influences on the Chinese political, economic and cultural sphere. Some observers warned the society that the state may be captured by special interest groups. To some extent, this did erode the agenda setting capacity. For example, it is a consensus among most Chinese that workers and staffs wages should be increased as soon as possible, but after 3 years of drafting and discussion, the Chinese government has not issued the new Wage Ordinance. However, facing the problems caused by privatization and marketization and seeing the disastrous consequences of neoliberalism in Latin America and the former Soviet Union, the Chinese government began to resist neoliberalism and reversed some policies implemented in the 1990s. For instance, after learning lessons from the SARS crisis in 2003 and under the pressure from the public dissatisfaction, the Chinese government began another round reform of the healthcare system reversing the 1990s reform. Besides, as we will see below, the government revenue keeps rising fast in this period and public enterprises gained more and more support from the state. Furthermore, there are some signs that the Chinese government may pay more attention on Marxism in the near future. At several occasions, the vice president of China, ask the high level officials to read the classical work of Marxism and the revolution history of China. That means that neoliberalism may gradually lose its influence on the Chinese government in the future.

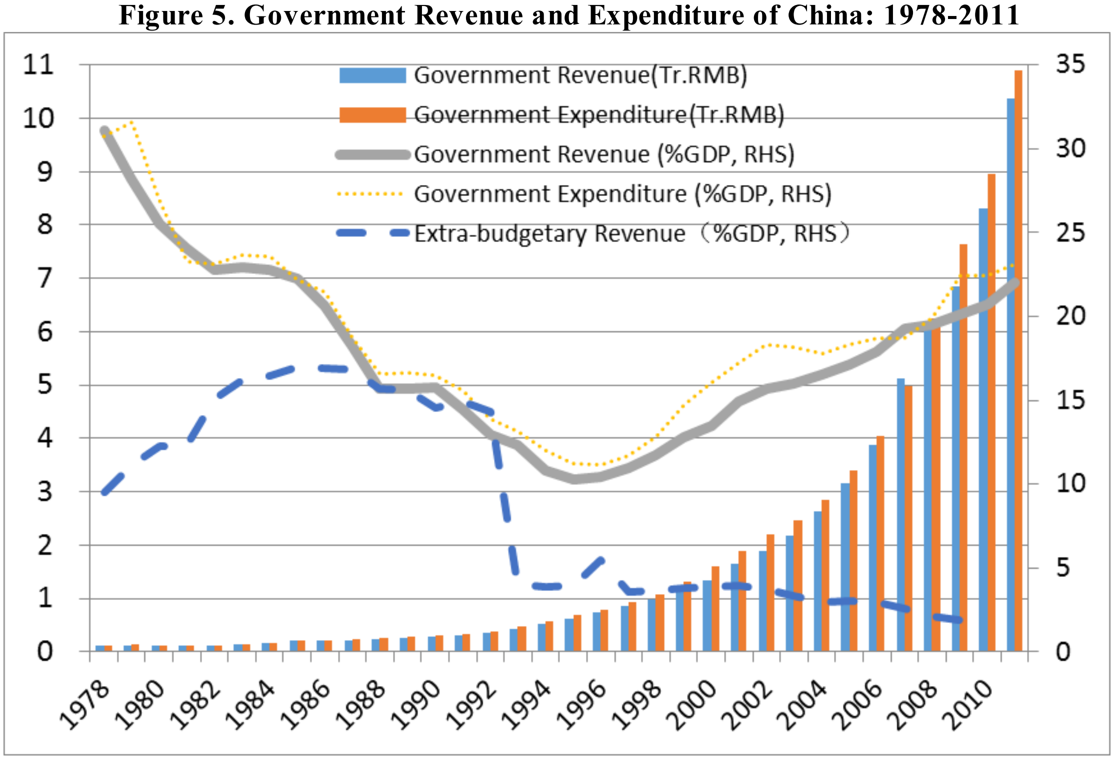
Second, the extractive capacity of China's state decreased before the mid-1990s and then recovered to the early-1980 level. In order to motivate enterprises and local governments to pursue greater efficiency, the Chinese central government carried out an important reform, namely in Chinese, *fang quan rang li*, i.e., devolve control over resources and decision-making power to subnational governments and enterprises. For subnational governments, "eating in separate kitchens" (*fen zao chi fan*) was introduced in 1980 to expand their fiscal autonomy, while fore state enterprises, a larger proportion of profit is allowed to retain for their own uses.

Together with other reforms, the extractive capacity of the state was eroded. Figure 5 shows the government revenue (including extra-budget revenue) and expenditure of China in the reform era. There are several points worth mentioning. First, the Share of the government revenue in GDP decreased from31.1 per cent in 1978 to 10.3 per cent in 1995. Even if we add in the extra-budgetary revenue, the basic trend didn't change. The share of total government revenue (on- and off-budget) in GDP decreased from 40.6 per cent in 1978 to 27.3 per cent in 1992. Second, within the budget revenue, the central government's share dropped sharply, from 40.5 per cent in 1984 to 22 per cent in 1993. As a result, the authority of the central government was weakened, especially in those coast provinces which are relatively richer than other regions and have more revenue at hand. Third, extra-budgetary revenue increased to a level higher than budgetary revenue. In 1978, the former was only RMB 34.7 billion (9.5 per cent of GDP), but is 1992, it increased to RMB 385.5 billion (14.3 per cent of GDP), RMB 37.2 billion (1.4 per cent of GDP) higher than the budgetary revenue. This further weakened the authority of the national government over subnational governments and enterprises.

With the extractive capacity weakened, the state had serious difficulties to fulfil its responsibilities. For instance, the expenditure on national defence was decreased from the late 1970s to the mid-1980s. In 1986, defence expenditure was RMB 20.1 billion, only 2.1 per cent of GDP. The share of this category in GDP kept declining until 1997, when it falls to 1.3% of GDP. Because the government spending is not enough for the development of the defence sector, the military set up their enterprises to do business, this cause a lot of problems, including corruption. In this period, almost all the sectors financed by government spending, to some extent, are lack of money to run their normal business. For example, there was a national wide wage arrears phenomenon for teachers in late 1980s and 1990s. Many local governments in the rural area chose to create various programs to raise money to keep them running. Besides the influence of neoliberalism, this situation encouraged the state to private public enterprises, commercialized the healthcare and education system, for raise or save money.

Facing such a difficult situation, in 1994, the central government carried out a comprehensive reform of central-provincial fiscal relations and began to establish a new fiscal system, known as the tax-assignment system (*fen shui zhi*). It was in that year, the central government's share in total government revenue increased to the current level (a little higher than 50 per cent) from 22 per cent in 1993. The recovery of total government's share in GDP is slower, but after 1995, it keeps rising, and in 2011, it reached 22 per cent, comparable to the mid-1980s level. With more and more financial resources at hand, besides fulfil its own other responsibilities, the state began to invest in infrastructure sector, improve the welfare system, abolish agricultural tax, etc. These activities not only won more support from the public, but also improve the foundation for future development. Of course, though some observers criticize the government for taxing too much from the economy, comparing to other high and middle income countries, the share of government revenue in GDP is not high at all. Furthermore, as a big developing country, the state has many obligations and the current level of revenue is not enough to meet the needs of the public.

Figure 5. Government Revenue and Expenditure of China: 1978-2011



Source: China Statistical Abstract 2011 (for data before 2011); the website of National

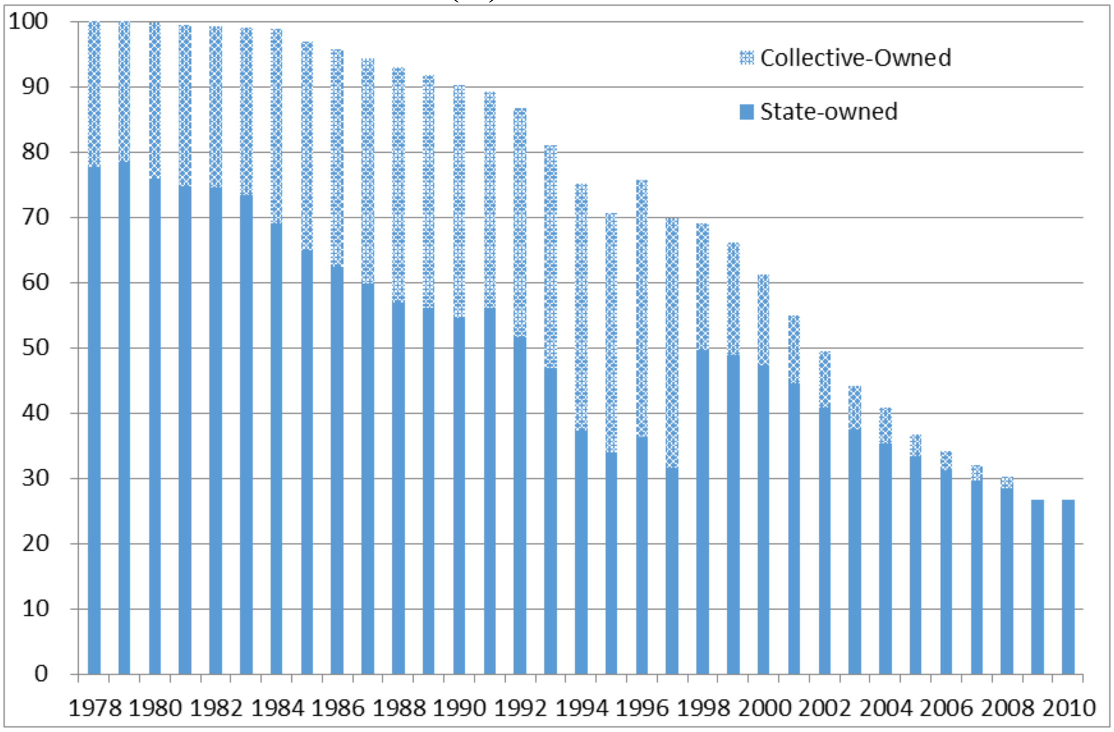
Bureau of Statistics of China and the Ministry of Finance of China.

Third, the state economic management capacity in China has been eroded but remains relatively high. This capacity has broader content than the conventional ability to use fiscal and monetary policies. It should also include the ability to motivate the related organizations to follow the state's guidance to develop and manage the economy, and the ability to make these organizations big and strong enough to complete the missions assigned to them. Here, the term organization mainly refers to subnational government and state-owned enterprises (and financial institutes). For the first ability, with the reform process, these organizations did gradually develop their own interest, which is not necessarily coinciding with the national interest. For example, local government may sacrifice long-term benefits for short-term goal, sacrifice environment for economic growth; and state-owned enterprises may put profit rather than public interest on top of their agenda. Therefore, this aspect of the state economic management capacity was weakened. However, until now, the state still has relatively effective control over the subnational government and public enterprises, and economic growth, social and economic stability are the common interest of all these entities. Then, the following question is how big and strong are these organizations. Now, with the rapid increase of government revenue, especially the central government revenue, the subnational governments, in general, is quite strong to implement those policies they are willing to do so. Here, I will focus on the state-owned banks and enterprises.

At the beginning of the reform era, there was not commercial bank operating in China, even more surprising to today's observers, there was no central bank in China, because in a planning economy, neither of them is necessary. In 1978, the People's Bank of China (PBC) was created and became independent of the Ministry of Finance, and in 1984, it was specifically designated as the central bank of China. In 1980s, four so called specialised banks were established and in 1995 were transformed into commercial banks. They are the big-four state-owned banks: the Industrial and Commercial Bank of China (ICBC), the China Construction Bank (CCB), the Bank of China (BOC), and the Agricultural Bank of China (ABC). In 1994, three new policy banks, the Agricultural Development Bank of China (ADBC), China Development Bank (CDB), and the Export-Import Bank of China (Chexim), were established to take over the government-directed spending functions of the four state-owned commercial banks. In the past two decades, many commercial banks were set up in China and most of them were state-owned. It was in 2000s, most of the commercial banks, including the "big-four", were transformed into joint stock firms and listed in the stock market. Part of their shares was sold to foreign and domestic investors. Or in other words, they were partly privatized. However, the Chinese government regarded the banking system as one of the most important strategic sector and exert relatively tight control over it. Until now, the state still owns the biggest share in many Chinese banks and has relatively effective control over them. Therefore, though profit is one of the most important targets for these banks, unlike the European and American banks, in the current world financial and economic crisis, when the state decided to stimulate the economy with more money supply, the Chinese banks did lend money to the real economy. Furthermore, the Chinese economy heavily relies on bank financing. At the end of 2010, the total market capitalization was RMB 26.5 trillion, while the total domestic loans were RMB 47.9 trillion. So, we may insist with some confidence that China's state financial capability is still very strong.

Another important entity the state could utilize to manage the economy is public enterprise. In China, the public enterprises emerged from those public factories in the planning economy before the reform. In 1980sand early 1990s, the Chinese government allowed, sometimes encouraged, the development of private firms. The public firms experienced rapid development too. In industry, the number of state owned enterprise increased from 83,700 in 1978 to 104,800 in 1991, and collective-owned firms increased from 264,700 to 389,200, while private firms from zero to 10,800. As a result, the share of public enterprises (including both state-owned and collective-owned) in industrial output fell from 100 per cent to 89.2 per cent in the same period. (See Figure 6) Facing the high level of inflation in 1988(18.8 per cent, CPI inflation) and the Tiananmen Square event, the state intentionally cooled down the economy by cut public investment. This causes many public firms to suffer losses due to insufficient demand for their products. Therefore, the request for subsidies increased sharply. However, as mentioned above, the state extractive capacity is at its lowest level at this time and the government was troubled with fiscal deficit. Combined with the influence of neoliberalism, this difficult situation led the government to initiate a wave of layoffs and privatizations starting in the mid-1990s. At first, the layoffs were small, in the single year of 1998, 29.1 million employees were laid off from state- and collective owned enterprises. Between 1996 and 2005, 47.7 million state-owned enterprise workers lose their job, while from 1992 to 2005, 28.2 million was laid off from the collective owned firms. Between 1992 and 2005, total urban employment rose by 117.9 million due to rising private sector employment. This led to the informalization of the Chinese labor market and sluggish wage increases. As the privatization movement gathered momentum, most of the public enterprises fell into the hands of private owners. From 1991 to 2010, the number of state-owned industrial enterprises decreased from 104,800 to 20,300, and its share in industrial output dropped from 56.2 per cent to 26.6 per cent, while collective-owned firms' share fell from 33 per cent to 1.3 per cent (in 2008). Together, these two sectors account for around 30 per cent of total industrial output. (See Figure 6)

Figure 6. The Share of State- and Collective-owned firms in China's Industrial Output (%):1978-2010



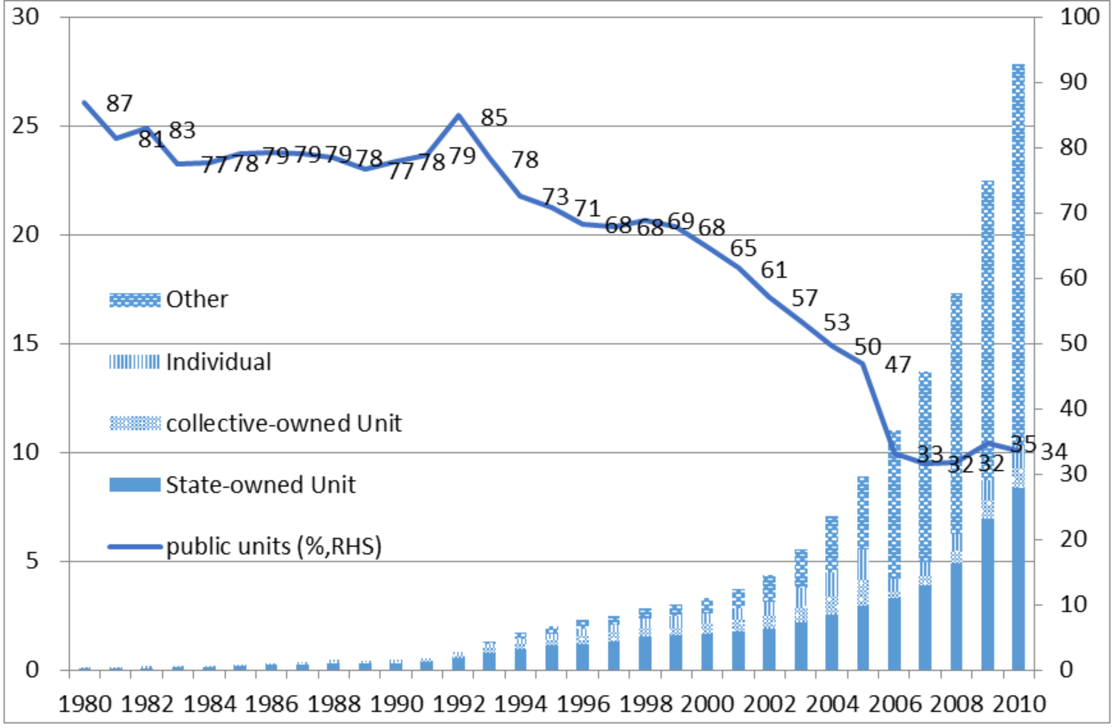
Source: China Statistical Yearbook, various years

These factors had a fundamental and lasting impact on income distribution. The gini coefficient rose from 0.25 in 1984 to 0.46 in 2006. Furthermore, the high level of income inequality, accompanied by the growing burden of commercialized healthcare, education, and housing, led to a rising saving ratio. All these factors contributed to the low and decreasing household consumption share in GDP, which, in turn, required the Chinese government to heavily rely on investment and export to achieve economic growth.

However, comparing to other countries and the need to stabilize the economy, the public enterprise sector may still be relatively strong.

Just as John Maynard Keynes correctly pointed out, the market economy is inherently unstable and the most unstable component of GDP is private investment.Following Keynes's thought, Hyman P. Minsky wisely insisted that in order to stabilize the unstable market economy and avoid depression, the government should be big enough, at least being comparable to private investment.In the Chinese case, economic growth heavily relies on investment and exports. Not only private investment, but also exports, is an unstable force. At the same time, state-owned enterprises may operate counter-cyclically and stabilize the economy. Therefore, following Minsky's argument, the government size (measured by its revenue) plus the state-owned enterprise sector should be larger than the sum of private investment and net exports.

Figure 7.China's Total Investment in Fixed Assets by Ownership (Tr. RMB): 1980-2010



Source: China Statistical Yearbook, various years

Figure 7 shows total fixed asset investment in China by ownership. We can see, the basic trend of public enterprises' share in fixed asset investment is similar with their share in industrial output. In the past several years, the ratio was around 33 per cent. From figure 2 we can see the total investment was 48.6 per cent of GDP. If we ignore the inventory, then, by multiply these two ratios we can get that public enterprises' investment is about 16.2 per cent of GDP and private investment is 32.4 per cent of it. And in 2010, net export is 4 per cent of GDP, government revenue, 22 per cent. The sum of government revenue and public investment is a little bit more than the sum of private investment and net exports. Therefore, we may conclude that with the current government size, the public enterprises sector is big enough to stabilize the economy. Or in other words, the state economic management capacity is strong enough to absorb external and internal shocks. What happened in China during the current international financial crisis demonstrated this.

In fact, in the short run, China can survive more shocks. Besides what we have discussed, there are several points worth mentioning:

1. China accumulated huge amount of foreign reserves. At the end of 2011, it reached $3.18 trillion. On one hand, given the current world financial structure, China suffers a lot of losses from it and exposed to serious risks. On the other hand, it strengthens the state capacity of China to handle related international problems. For instance, total outstanding external debt was $549 billion at the end of 2010, less than 20 per cent of foreign reserve in the same year.

2. There is still enough space for the state to use fiscal policy to manage the economy. The outstanding central government debt was about 20 per cent of GDP at the end of 2010. Even after adding the local governments' RMB 10.7 trillion debt (26.9 per cent of GDP) and the 6 per cent of bonds issued by those policy financial institutes, the ratio was about 50 per cent, still lower than the internationally recognized warning line of 60 per cent. The difference, 10 per cent of GDP, comparable to 4 to 5 trillion Yuan. Furthermore, unlike the European or the US case, most of the local governments' debt in China was invested and not all of them were lost.

3. There is still enough space for the state to us monetary policy to manage the economy. Since October 2010, the central bank increased interest rate 5 times, from 5.31 per cent to 6.56 per cent (one-year loan). More importantly, the required reserve ratio is staying at a very high level, 21 per cent for big financial institute. At the end of 2011, total deposits in the Chinese financial institutes were 82.7 trillion Yuan. Decreasing the ratio by 1 percentage point will increase money supply by more than 800 billion Yuan. 5 percentage points can increase more than 4 trillion Yuan of money supply.

Some observers are concerned with the burst of real estate bubble in China. It is true that the bubble is bursting. However, according to Liu Mingkang, the chairman of the China Banking Regulatory Commission, in general risks related to the real estate are still controllable. At the end of August, 2011, banking institutes' outstanding loan to the real estate sector was 10.4 trillion RMB, only 19.8 percent of total loans.

In one word, just as we have seen during the East Asian Financial crisis in 1997 and the 2008 international financial crisis, China's state capacity is still relatively strong and can handle China's problems in short run. But how about the long run?

4 CONCLUDING REMARKS: THE OPPORTUNITIES AND CHALLENGES

In the long run, China has to reverse those unsustainable trends discussed in section 2. The unsustainable reliance on investment and export can be solved by increasing the household consumption ratio, which, in turn, can be solved by raising the share of labour income, lowering income inequality and improving the welfare system.

Increasing the income of ordinary people and reducing income inequality can be done mainly in the primary and secondary stages of the income distribution process. To improve the primary distribution, the Chinese government could nationalize or renationalize private and foreign firms, and implement, and enforce stricter regulations in the labor market. The former policy can prevent the surpluses from falling into the hands of a small group of individuals or being sent abroad, instead distributing them to the workers. The latter can secure decent wages and other benefits for the workers, including the large numbers of migrant workers who face low wages and harsh working conditions. Together, these measures would improve the workers' bargaining power and increase their income.

Besides, the state should make the people save less and spend more. Only when people do not worry about paying their child's education, their family members' illness, or housing, they could be confident to consume. This requires the welfare system to be improved in china. The health care and education systems should be de-commercialized further, and the real estate sector should be much less profit-oriented. Though the Chinese government already recognizes these problems, the policies carried out so far have either not been effective enough, or too slow.

All these measure can not only solve the problems mentioned above, but also strengthen the state capacity. In order to realize these goals, the extractive capacity should be improved too. With more money at hand, the state can transfer more income to the poor, and the welfare system can be improved.

However, these policies would face serious challenges. The most serious resistance would come from those groups that have benefited the most from the current growth pattern. What makes things even worse is that these groups are the elites currently controlling most of the political, economic, and cultural resources and have important influences on the designing and implementation of laws and policies.

But there are still opportunities to make these changes. First, as mentioned above, China now seems to experience the Lewis turning point and the workers' wages are rising rapidly in the past several years. Under these conditions, the workers, including those migrant workers, will be more confident to organize and struggle for higher wages and better benefits. Second, because China has much better infrastructure and clustering of industry, and bigger market, than those countries with lower labor cost, for at least one to two decades, the mainland will still be a favorable place to invest. Third, as discussed above, China's state capacity is still relatively strong. In the short run, the government has the ability to maintain economic growth and social stability. Besides, the state is responsive to the public voice and has some autonomy. Fourth, the 2008 international financial and economic crisis not only disproved neoliberalism, but also revealed the plutocracy in the western countries.

Therefore, there are some opportunities to make the Chinese economic growth more sustainable. However, in order to capture these opportunities and defeat the opposition of those interest groups, the state capacity needs to be strengthened. Only when the state is strong enough to resist the pressures exerted by foreign and domestic interest groups, those changes will be made. For this to take place, the ordinary people need to be mobilized and organized to stand behind the state.