5 Evaluation and lessons from China's model of economic development

China's capability to leapfrog up the developmental hierarchy in its economic growth and industrial development since 1978 has been the central interest of this analysis. While previous studies analyzed different aspects of China's development approach with regard to the East Asian developmental state theory, this study "translated" the experiences of the three East Asian developmental states Japan, Taiwan and Korea into specific criteria (institutional setting and policy indicators) for successful economic transformation. An East Asian Developmental State Model was set up and used as a role model to systematically analyze China's development. The analysis, moreover, concentrated on the effectiveness of China's model of economic development, using the auto industry as a basis for empirical research. From the mixed-methods approach (analysis of secondary statistics, statistical evaluation of the World Bank sample and up-to-date expert interviews) new insights into state-guidance in one of China's key sectors could be gained. From the results one can infer that Chinese auto manufacturers have benefited from the government's policy for the sector. However, continuous policy and government intervention in business activities, e.g. by state-ownership, local protectionism and strict requirements on foreign investors, has restricted competition and the sector's full development potential.

5.1 China – the new developmental state

The analysis of China's economic development rests upon the political economy approach of the developmental state theory, which is one of the most persuasive attempts to explain East Asian success. The developmental state model is based on continuous but selective state interventions in markets and firms to shape the course of economic development. The authoritarian developmental states' industrial guidance has enabled these late-industrializing economies to mount and sustain high levels of economic growth. The analysis confirmed that during the post-Mao economic reforms, China has evolved into a transforming state similar in most of its core characteristics to the East Asian developmental states:

- Like the East Asian developmental states, China's central leaders undertook economic reforms prior to political reforms and have retained the authority to crush dissent. Bureaucratic reforms facilitated better educated leaders supportive of economic reforms.
- From the beginning of its reform, China has strived to achieve economic growth and industrial transformation by a strong involvement of the government. The Chinese developmental state has followed the East Asian government-led development model in which industrial policy plays a central role in directing economic development. The central government has issued national industrial policies in the form of five-year and annual plans based on a

1159 Refer to Nee (1992), pp. 24-25.
comprehensive long-term strategy. The elite bureaucracy in China, like that in the East Asian developmental states, has actively intervened in the economy by guiding, disciplining and coordinating the market in order to achieve its economic development goals. Despite the WTO principle of "national treatment", no level playing field for all economic subjects exists in China. As a result, the allocation of resources and therefore the industrial structures created are to a considerable extent not the outcome of market processes but rather the central government's industrial design.\textsuperscript{1160} The analysis showed that the Chinese developmental state has continuously modified its policies in a creative and innovative manner, in accordance with the prevailing development strategy as well as the changing domestic and international environment.\textsuperscript{1161} In this way, one strength of the Chinese model is its constant adaptation.

- Like their East Asian counterparts, central leaders in China have used different industrial policy mechanisms (selected protection of, and preferential treatment for, specific "sunrise" industries, such as tax reliefs and credits at low interest rates) as well as trade policy (import substitution and export promotion) to develop the national economy. Policy support has consisted of the selective adoption of regulations in accordance with the appropriate pace and pattern of the transition towards a market economy.

- As in the East Asian developmental states, Chinese enterprises have been supported by the government's "national champions" policy. Enterprises such as Lenovo have already reached a developmental stage where they are competitive in the global markets.

- The Chinese state has constructed a positive economic and investment climate through the gradual liberalization of product and labor markets, increasing openness to foreign trade, infrastructure investments, property reforms and privatization. Its institutional reforms have provided economic agents with security for planning, investing and economic risk taking. The state has had the capacity to construct an institutional environment that provides positive incentives to entrepreneurs and managers at the firm level to invest in economic growth.\textsuperscript{1162}

Therefore, China's economic performance since 1978 can be attributed to the adoption of the development strategies previously implemented by Japan, Korea and Taiwan. The analysis of China's economic development, using the East Asian Developmental State Model as a role model, confirms that China's path of development makes it the latest member of the group of successful developmental

\textsuperscript{1160} Refer to Taube (2005), pp. 5-6.

\textsuperscript{1161} This has been the case, in particular, in the run-up to, and in the aftermath of, its accession to the WTO. Refer to UNCTAD, "Key Issues in China's Economic Transformation", Internet Edition, reviewed 12.02.2007.

\textsuperscript{1162} Refer to Nee et al. (2007), p. 43.
states. This assertion is in line with previous works on China such as Nee (1992), Nee et al. (2005), Wu (2000), and Stiglitz (2002).1163 This study in consequence reinforces their results by using a different research approach. Although the analysis proved that the Chinese reform experiment shares core characteristics with the developmental states in East Asia, one should not conclude from this that China is following a coherent strategy of emulating the East Asian Developmental State Model.

5.2 Uniqueness of the Chinese development approach

The analysis of the Chinese developmental state’s approach towards restructuring its domestic industry, specifically the auto industry, exemplifies the uniqueness of the Chinese developmental state. The nation’s distinct path of development is characterized by an innovative form of state-led growth. China’s economic achievements over the past two decades have made its development experiences special in many ways.

Unlike the East Asian Developmental State Model, the Chinese developmental state pursues an economic development path characterized by decentralization and foreign investment. China has successfully incorporated both criteria in its development strategy, in order to spur local entrepreneurship and advance to international technology standards. Both characteristics particularly shape the development of the auto industry that has been used for empirical analysis. The analysis also showed that state ownership of central and local auto companies, as well as far-reaching government intervention in business activities, have had negative economic consequences.

(1) Decentralization:

Crucial to China’s economic success, decentralization has assigned local governments’ considerable discretion over economic policy. In many areas, officials have used this authority to create markets and build up internationally active companies.1164 With the introduction of fiscal federalism, the local officials’ revenues became positively correlated with the prospering of local economic enterprises.1165 The incentives applied have induced a change in bureaucrats’ behavior. Local governments have provided an entrepreneurial business environment. The municipal government in Shanghai (rather than its counterpart in Beijing), together with local business groups, fostered ties between auto firms and local university research institutes. They also attracted foreign investments in the auto sector, and supported

the establishment of a local supplier community. This development approach resembles active state-guidance in Japan and Korea. At the same time, the central government’s loss of control over local officials has directly limited its ability to intervene adversely. Without political liberalization, China transformed its bureaucratic system substantially during its reform process, and introduced market-based incentives at all levels of the bureaucracy.\textsuperscript{1166} In this respect, China did not pursue top-down planning like the East Asian developmental states, but rather a bottom-up approach of local state-led economic growth.

However, it was shown that this “Chinese-style federalism”, as an intermediate institutional arrangement, is not perfect. While representing the interests of the central government as state agents, local governments simultaneously act in accordance with local interests in competition with other jurisdictions, thus questioning official budgetary boundaries.\textsuperscript{1167} Under economic and political pressures, they assume the role of local economic principals, manipulate national economic policies to pursue particular local goals and defend local interests.\textsuperscript{1168} The central government tolerates, and even rewards, officials who use any means to produce local investment and employment knowing that local economic growth promotes social and political order. The pursuit of independent policies at various government levels has frequently impeded a coherent policy approach. In the auto sector, economic (fiscal) decentralization has created incentives for local governments to support the development of local auto firms and sometimes flout the interest of the central government and its long-term policy approach. National import substitution for the auto sector in combination with local protective high tariffs and market restrictions have led local governments to launch new independent auto assembly projects in anticipation of high profits.\textsuperscript{1169} While the central government aims to guide the development of the sector, its policy approach is impeded by various local bureaucracies that established provincial auto bases in order to stimulate local economic growth. This has provoked duplicate construction and fragmentation and has hindered the consolidation of the auto industry.\textsuperscript{1170} The Chinese economy is therefore characterized by politically monopolized and isolated local markets.

\textsuperscript{1166} Refer to Tenev (2006), p. 24.
\textsuperscript{1167} Refer to Gong (2006), p. 94.
\textsuperscript{1169} The central government pursues import substitution for the auto industry rather than export promotion as in other sectors. In order to protect domestic firms and lessen foreign exchange outflows, the government imposed high tariff rates, quotas and import licenses on foreign-made motor vehicles. Protectionist measures and deterred international competition generated high prices and profits in the domestic market. The analysis showed that China has used local content and certification measures and imposed high tariff rates on vehicles and selected auto components even after the transition period of China’s WTO accession.
\textsuperscript{1170} The same applies for the domestic auto supply industry which is fragmented and uncompetitive compared with international norms, with little economy of scale.
Evaluation and lessons from China's model of economic development

Altogether, a key determinant of China's development strategy is the uncertain and unclear relationship between central and local authorities. The central government has increasingly been unable to force provincial authorities to adhere to central government policy directives. Until and unless this relationship is stabilized, it will be extraordinarily difficult to develop a coherent and cohesive national strategy for development: in Johnson's words, to facilitate "the national mobilization of a united people for economic goals".\textsuperscript{1171} China will need a strong, integrating central authority (like the pilot agency in the East Asian developmental states) to bring entrepreneurial initiatives into a rule-based national context.\textsuperscript{1172}

(2) Foreign investment:

Maybe the most defining feature of China's economic reform is its approach towards FDI.\textsuperscript{1173} In order to spur its national modernization drive, the Chinese developmental state has attracted foreign investment. China's FDI policies have been proactive, both at the central level and the provincial and municipal level.\textsuperscript{1174} The Chinese developmental state is more open towards foreign participation than its East Asian counterparts were at a comparable stage of development. By welcoming foreign investment, China has linked its domestic industry to international markets which is increasingly important in times of globalization. FDIs that have entered China since the 1990s have clearly benefited China's modernization efforts and its global competitiveness. The analysis of the auto sector showed that the central government implemented a sector-specific policy, relying on foreign auto manufacturers to build JVs with selected local SOEs or cooperatives and collectives. In this way, domestic state-owned companies were to overcome their technology shortage and establish a modern car industry with the help of foreign OEMs. While in several post-socialist East and Central European countries, and in many other developing countries, the auto industry is dominated by MNCs, the central government has successfully prevented domination of auto production by foreign manufacturers with this regulation.\textsuperscript{1175} Sino-foreign contract or venture agreements, as well as foreign high-tech R&D investments, have caused positive spillover effects (e.g. job creation, local production and sourcing, and modernization of the domestic auto industry).

Although foreign investment in the auto industry has contributed positively to the sector's modernization, in the segment of passenger cars, Chinese car manufacturing is not yet competitive in global markets. The strict regulation on FDI inputs has had negative effects by contributing to domestic auto manufacturers' dependence on foreign technology and know-how. While evidence is limited, the analysis provides indication that assistance from the state (and subsequently foreign

\textsuperscript{1171} Refer to Johnson (1987), p. 139.
\textsuperscript{1172} Refer to Taube (2005), p. 7.
\textsuperscript{1173} Refer to Pei (2006a), p. 3.
\textsuperscript{1174} Local governments even compete for foreign investments as their jurisdictions' financial well-being (through fiscal federalism) and their own political career depend on local development.
\textsuperscript{1175} For further information refer to Pavlinek and Smith (1998) and Swain (1998).
Evaluation and lessons from China’s model of economic development

investors) has served as a substitute for domestic entrepreneurship, and weakened
the competitiveness of Chinese auto firms. The most ambitious and innovative
Chinese auto companies are private manufacturers, or manufacturers with little
government participation, and outside the central government’s center of attention
such as Geely and Chery.

Many domestic auto manufacturers concentrate on short-term gains, rather than on
increasing operational efficiency and commitment to developing new technologies.
Although the central government provides incentives for domestic companies to
invest in long-term technology development, Chinese firms often focus on developing
privileged relations with officials in the CCP hierarchy, and rely on guanxi, to realize
short-term profit. State and private auto firms in China (whether in Beijing, Shanghai
or other jurisdictions) lag behind foreign OEMs, because they have failed to invest in
the type of long-term technological capabilities that their Japanese and Korean
predecessors built during the 1970s and 1980s. This poses an ongoing dilemma for
Chinese policy-makers: Not only do Chinese officials fear being cut off from foreign
technology; they also fear becoming too heavily dependent on it.1176 This is a realistic
concern, given China’s still-limited indigenous high-tech capabilities in the auto
industry, and foreign investors’ engagement to gain market share in the domestic
market. China’s industry is left with inefficient but still-powerful Chinese SOEs,
increasingly dominant foreign firms, and few profitable private auto firms.

The capability to export can simply be used to evaluate the international
competitiveness of firms. Industrial policy in the East Asian developmental states
aimed at cost and price competitiveness in world markets. Subjecting domestic firms
to international competition is generally considered to be a crucial concern to
promote the development of them – certainly when the economy is integrated in the
world economy and abides the rules of the WTO. Chinese auto manufacturers,
however, are not yet internationally competitive and thus exports, of mostly small
domestic manufacturers, only increase slowly. As long as domestic auto
manufacturers are not capable of producing and selling cars on global markets, the
central government will not give up its “infant industry” policy of assistance through
protection and limited equity stakes of foreign investors. China’s industrial policy, as
highlighted by the analysis of passenger car industry, is not able to ensure
competitive conditions in markets due to a specific combination of restrictive and
regulatory policy measures, mainly reflected by entry restrictions. In the mid- to long-
run, protection must be gradually reduced and the domestic auto market must further
open up to international competition in order to increase the competitiveness of its
domestic auto producers.1177 Chinese companies must expand their R&D
capabilities, including new product design and advanced manufacturing techniques
to become global players. Besides, they will have to invest heavily in manufacturing
facilities in order to accommodate new vehicle designs.

1177 The restrictions on auto imports and on the operations of foreign firms in China have already been
reduced since China’s WTO entry.
(3) Government intervention in business activities and state ownership:

While the governments of Korea and Taiwan, following the Japanese path, were deeply committed to market mechanism and private ownership, the Chinese party-state remains in direct control of large parts of the economy through ownership of dominant enterprises in strategic sectors.\(^\text{1178}\) In the auto sector, state bureaucrats and SOEs exploit their bargaining power to influence the formulation of industrial policy and pursue further rents. Particularly SOEs, as targets of strong government support, have the strongest influential power for the formulation of the industrial policy. The analysis of the auto sector showed that state ownership of key auto firms and Chinese bureaucrats' direct intervention in free market mechanisms have caused economic inefficiencies. The high level of prices and profits has been evidence of the lack of competition in the industry, resulting in welfare losses. The protectionist model of regulation in the name of industrial policy persists, because of the special consideration of the government given to the strategically important and politically sensitive large-sized SOEs which are a guarantor of employment. Moreover, state bureaucrats in China did not have the power to demand from the high-priority auto sector to meet performance goals as in the East Asian developmental states.

The withdrawal of government from business activities has happened only partially in China. Following the privatization of TVEs and small- and middle-sized SOEs in the early 2000s, local governments are less involved in influencing economic decisions within the firm as they attempt to improve the business environment to attract entrepreneurs and investments to their region.\(^\text{1179}\) In the auto sector, however, state ownership and government interference in business activities is still widespread.\(^\text{1180}\) The development of local governments' dual role as both state agents and local economic principals, has allowed local government officials to remain at the center of economic activities. Public power and private economic interests have become intimately connected.\(^\text{1181}\) When enterprises are owned and controlled by the state, economic decisions necessarily become political decisions, and price competition is supplanted by forms of personal competition driven by the quest for political power and privilege. Bribery and corruption then become the rule rather than the exception. The resulting uncertainty surrounding economic transactions destabilizes economic development.\(^\text{1182}\) Chinese authorities have so far refused to decontrol markets and prices in large segments of China's vast economic landscape.

The state's economic dominance preserves systemic economic inefficiency, as scarce resources are funneled to local elites and bureaucratic constituencies.

\(^\text{1178}\) Refer to Nolan (1993b), p. 206.
\(^\text{1179}\) Refer to Nee and Opper (2007), p. 123.
\(^\text{1180}\) In the electronics sector, by contrast, "regulatory capture" is less pronounced due to a relatively weak position of large SOEs owned by the central government.
\(^\text{1181}\) Refer to Gong (2006), p. 99.
\(^\text{1182}\) Refer to Dorn (1989), p. 564.
Evaluation and lessons from China's model of economic development

Tensions rise between economic modernization and the many institutional flaws of authoritarian rule (e.g. lack of political accountability, weak rule of law, and corruption). To activate the full potential of China's distinct developmental model, and overcome structural imbalances in the industrial economy, further progress toward instituting a market economy is needed. As in the capitalist East Asian developmental states, private property rights need to be put on an equal basis with other forms of ownership, creating legal norms and regulations – and the means to enforce them – that protect private property rights. In particular, a constitutional framework, which insulates economic life from political opportunism, appears to be a necessary condition for social and economic stability. In the following years, governments at every level need to be gradually phased out of economic activities, and to return to social and political management.

Ultimately, economic and political reforms are inseparable. As long as the ruling elite prevents the full expansion of free market mechanisms, the quest for economic and social stability will fail to be realized. Fearing that a more comprehensive approach would threaten the supremacy of the CCP, the Chinese government has consistently resisted steps to further reduce the role of the state in the economy and increase judicial independence. In short, economic reform in this kind of political system will inevitably be piecemeal, and the transformation to a full market economy fail, as further reforms diminish the ruling regime's power and threaten its survival. In the long run, reformers might build up a modern polity with open electoral politics that moves China beyond an antiquated CCP dictatorship. The question remains as to whether China can, like many of its East Asian neighbors, evolve along a neoauthoritarian development path, and move eventually toward a more open society.

To summarize, the analysis showed that China adapted the East Asian Developmental State Model to a particular Chinese type of developmental state, which is a hybrid form of strategies advocated by different streams of development thinking. The regulation mechanism of economic development in China is an

---

1184 The CCP is aware of this situation. This becomes apparent when studying the latest policy document, the Eleventh Five-Year Plan. The plan focuses strongly on social balance within the country. Of the 22 goals, only two relate to economic growth - total GDP and per capita GDP - and four to changes in economic structure - share of services in the economy and in employment, spending on R&D, and the urbanization rate. The other 16 relate to population growth, use of resources, the environment, and standards of living. Refer to National Development and Reform Commission (2006), "Outline of the Eleventh Five-Year Plan for National Economic & Social Development of the People's Republic of China", Internet Edition, reviewed 14.11.2006.
1185 To come into line with international legal reforms, China has undertaken economic legal reforms, although questions remain as to the judiciary's independence from the CCP.
innovative combination of factors from the East Asian developmental states, the legacies of the past command economy as well as of the newly adopted market mechanism, including international capital flows. In implementing economic policy, China has adopted a gradual approach, with an emphasis on stability, reflecting the fact that it takes time to improve the infrastructure of the market-based system, including the legal and regulatory framework, banking system, accounting standards, professional expertise, and institutional capacity.\textsuperscript{1187} Far-reaching government intervention in business activities, and the absolute rule of the CCP, however, hinder the full potential of the distinctiveness of the Chinese developmental state. China will approach a mature developmental state, though unique in its characteristics, once an independent legal system protects private economic agents from arbitrary state intervention.\textsuperscript{1188}

5.3 Lessons from China's new model of economic development

China's experience highlights the principle that "institutions matter" in understanding the diverse economic performance of different countries. China is already becoming an exporter of economic know-how, providing lessons in growth-promotion to its neighbors. As Tenev (2006) states, India is examining China’s experience with special trade and investment zones, and Vietnam is paying attention to China’s experience with state-enterprise reform.\textsuperscript{1189} Accordingly, the analysis intends to transform the results of the Chinese development strategy into specific criteria valuable for other transforming countries. These lessons, however, do not mean to provide a "blueprint" of economic transformation for developing countries. Different governments have different capacities to guide the market. Developmental objectives might not only differ from country to country, but require selective approaches for different sectors. While a highly interventionist policy might suit one sector best, it might be counterproductive in another, which needs a more laissez-faire approach.\textsuperscript{1190}

China’s model of economic development is intertwined with its unique political model. Moreover, China occupies an unrivaled niche in the world’s political economy – its vast populace and large geographical size alone accords it global influence. Accordingly, no lessons can reliably be extrapolated from China’s distinctive development path.\textsuperscript{1191} From the analysis, it is possible to look at the Chinese experience and draw seven premises in the field of reform – which do not claim to be exhaustive - for transitional and late industrializing economies:

\textsuperscript{1187} Refer to Hu (2007), p. 37.
\textsuperscript{1188} Refer to Nee and Opper (2007), p. 123.
\textsuperscript{1189} Refer to Tenev (2006), p. 23.
\textsuperscript{1191} Refer to Tenev (2006), p. 23.
Evaluation and lessons from China's model of economic development

- **State capacity and insulation from the political demands of society:** The analysis showed the importance of the government's role, as an economy makes the transition from a command to a market-based economy. The central government elaborated and formulated the long-term development goals of China's development path, and clearly articulated its policy reforms. The analysis of the East Asian developmental states showed that strong state capacity is necessary for the development process, so that the regime retains sufficient power to control the course of reform. This should exist at both the central and local levels. Unlike weak authoritarian states such as Africa and Latin America, the Chinese central government maintained its ability to guide economic activity during the reform period. The state bureaucracy has persistently used its power to decide on the content and speed of reform, and actively guided the industrial development process. In China, however, state capacity and coherence have been impeded by the "solos" of local governments. State capacity is particularly necessary to ensure an institutional environment conducive to private-sector investments and economic growth.

- **Decentralization and local incentives:** Reform and transition in geographically vast countries do not have to be directed solely by a centralized, national government. In a large economy, decentralization serves as a good mechanism for creating appropriate incentives for productive private activities that foster economic prosperity. Fiscal decentralization increases the autonomy of local governments, and gives them the incentive to promote economic growth. The central government, however, must ensure that local governments operate with hard budget constraints, in order to guarantee that local authorities are accountable for their decisions. Transfers between levels of government must be rule-based, expenditure responsibilities must be clearly allocated, and the ability of local governments to borrow funds must be limited. In addition, the national government must be able to circumvent local protectionism, which would impede domestic competition and preserve a common domestic market. Otherwise, effort and investment will continuously flow toward activities that are characterized by low productivity. As long as private-sector institutions are not developed sufficiently to fill the void left by government withdrawal, the complete removal of government from coordination activities (and thus a total reliance on market coordination) might not be feasible. Accordingly, different government levels should have adequate incentives to perform.

- **Openness to foreign trade:** The ability to graduate from import substitution to export promotion is a key factor in the successful pursuit of industrialization.

---

1192 Also unlike the USSR, which undertook political reform before beginning the task of economic restructuring.
1193 For further information refer to Burki et al. (1999).
1195 Refer to Aoki et al. (1997), p. 13.
1196 Refer to Oi (1995), p. 1147.
The key to developing countries’ export success is the early rejection of import substitution policies in favor of outward-looking policies.\textsuperscript{1197} Domestic companies’ export expansion depends on the policy package which does not shelter the imports of competing industries, but gives priority to export-oriented activities. Openness to foreign trade makes domestic companies measure their international competitiveness in foreign markets and prevents government officials from pursuing policy approaches that are no longer appropriate because it limits their ability to reduce the cost of mistake. Although import substitution is a necessary step to protect infant industries and to industrialize developing countries, there are serious problems associated with this strategy. The analysis of the Chinese auto industry shows that if protectionist measures such as tariffs are imposed for too long a period, protection may dampen the competitive edge of domestic firms. Protectionism may furthermore encourage new entry into the industry by domestic firms that aim to seek rents arising from high prices for locally produced vehicles.\textsuperscript{1198} The exposure of Chinese companies to international competition serves as a counterbalance to enliven nonprofitable companies by institutional incentives in the medium- to long-run.\textsuperscript{1199}

- **Attraction of foreign investments**: China’s open-door policy has spurred FDI in the country, linking the Chinese economy with international markets and importing technology and management know-how. Thus, domestic companies can adapt to international standards and become internationally competitive. This is particularly important in times of globalization and economic integration. China’s decentralized development model, in combination with its reliance on inward FDI, is an example of how regional development could occur in a continental-sized market economy. However, the danger that domestic companies might become subservient to FDI, particularly foreign technology, and weaken domestic entrepreneurship, needs to be eliminated by encouraging domestic investment in potentially dynamic private Chinese firms which compete with international companies.

- **Financial system**: The soundness and stability of the financial system is an essential ingredient of the appropriate macroeconomic framework for development.\textsuperscript{1200} In this regard, while policy loans may help to develop specific industrial sectors during the initial stage of economic reform, hard budget constraints on credit lending, and an independent financial supervisory body, are essential for the banking system once it has matured. Otherwise, crony capitalism might be the result.

\textsuperscript{1197} Refer to Ng et al. (1992), pp. 225-226.

\textsuperscript{1198} Berglas and Razin introduced the element of profits into the Stolper and Samuelson (1941) analysis of protection. They came to the conclusion that in the short run, protection is likely to increase profits. For further information on protection and real profits, refer to Berglas and Razin (1974).

\textsuperscript{1199} Refer to Thun (2006), p. 287.

\textsuperscript{1200} Refer to Elson (International Monetary Fund) (2006), p. 40.
Evaluation and lessons from China's model of economic development

- **Legal system:** China's path towards economic prosperity requires a modest legal infrastructure at a supra-individual level beyond social relationships, which is centered on the protection of property and contract rights. It is necessary for China to step up the establishment of a legal system, conforming to national conditions for opposing monopoly and guaranteeing fair trade. Developing countries need to make the transition from "rule by law" to a version of "rule of law". 1201 The rule of law promises to move countries past the first phase of political and economic liberalization to a deeper level of reform.

- **Retreat of the state in the long run:** Direct state intervention in free market mechanisms is likely to yield negative economic effects. While at the early stage of transition to a market economy, the "helping hand" of the government may be helpful or even necessary, 1202 the government is expected to gradually withdraw from direct involvement in the economy for the transition to be complete. As the economy evolves toward increased reliance on market mechanism, and as private property forms are backed by law and the state, the higher transaction costs of intervention by government bureaucrats act increasingly as a drag on economic performance. 1203 Political interference in economic life should decline in industrial sectors and regions, to the extent that an emergent market economy replaces the centrally planned economy. 1204 The state's functions should then concentrate on building market institutions, e.g., property rights, legal system and market structures, and realize the rational allocation of resources. 1205

The successes and failures of East Asia's and China's policy practices and their paths of technological progress indicate that as long as the economy is in a low state of development, the capabilities of firms are modest, and the efficiency of markets is hampered by poor integration and the underdevelopment of property-rights arrangements in the economy. Due to these unstable circumstances, the ability of the private sector to solve challenging coordination problems is suspect. During this time, government policy may successfully facilitate development. As the economy matures, however, the ability of the private sector improves, and the scope for policy becomes more limited. 1206 Overall, a state should create an environment that encourages market-oriented investment, ensure that the economy's dominant resource steering mechanisms are sensitive to economic efficiency, and "find" an engine of growth to generate dynamism and leadership. How these objectives are

---

1201 As Hayek puts it, rule of law "means that a government in all its actions is bound by rules fixed and announced beforehand - rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one's individual affairs on the basis of this knowledge". Refer to Hayek (1976, reprinted in 1994), p. 80.

1202 For further information refer to Frye and Shleifer (1997).

1203 Refer to Nee (1992), p. 23.

1204 For further information refer to Nee (1989, 1992).

1205 Refer to Nee and Opper (2007), p. 95.

1206 Refer to Aoki et al. (1997), p. 22.
Evaluation and lessons from China's model of economic development

best achieved in a particular economy depends on its own history as well as its external environment. Economic development does not call for a particular policy recipe, but it does require a disciplined, balanced approach to policy-making in order to achieve fundamental goals. Further studies might examine industries in different developing countries, and with different degrees of industrial dynamics. In this regard, this study intends to stimulate academic and policy debate on this topic. An international comparative approach might be a sound strategy.

World markets today will not tolerate large export subsidies as in the East Asian developmental states, and many of the technologies required to participate aggressively in world markets cannot be acquired anymore by copying or reverse engineering. This argues for more import and investment liberalization than was the case with the economies that based their development on export promotion in the 1960s.