Cracking Big Puzzle of China's Rise:
Andy Mukherjee
Commentary by Andy Mukherjee

April 30 (Bloomberg) -- One of the enduring mysteries of our times is how China has created capitalism out of thin air.

Throughout history, countries have needed to secure private- property rights and impose limits on state power in order for entrepreneurs to take risks, for bankers to lend money to people other than the king's cousin and for economies to grow.

Not communist China.

The spectacular success of the Chinese economy in the past two decades seems to suggest to many analysts that good institutions may not really be as fundamentally important to a country as they are cracked up to be.

This isn't an idle, academic debate.

Our perception of what makes China successful has serious implications for how we analyze the prospects for the rest of the developing world.

Most of us may believe that Robert Mugabe's undermining of democracy is bad news for Zimbabwe's economy.

But if we conclude that China created material prosperity and spawned wildly successful entrepreneurial ventures such as computer maker Lenovo Group Ltd. without constitutional democracy and its appurtenances, then we can't -- at least on purely economic grounds -- argue that Zimbabwe needs them.

Equally useless then would be the heaps of empirical evidence that economists have uncovered suggesting a causal relationship between property rights and growth.

If the most fascinating economic miracle of our times can soar in an institutional vacuum, then surely others can, too.

Stuck Needle

Now, that may only sound right to Mugabe and his cronies. So what's missing here?

The answer, according to Massachusetts Institute of Technology economist Yasheng Huang, is simple: The conventional view of China is deeply flawed.

Institutions, as Huang argues in his forthcoming book, titled ``Capitalism With Chinese Characteristics,'' have mattered as much in China as elsewhere, only their effect doesn't show up as neatly.

Part of the problem lies in measuring changes in the policy environment facing entrepreneurs on the ground. The ``authority trends'' for China, according to the widely used Polity IV database, moved toward totalitarianism at the start of Mao Zedong's Cultural Revolution in 1966, followed by a two-step return toward a slightly more free society in the 1970s. And there the needle stops.

"If the Chinese peasants had relied on the Polity IV to judge their property rights security, none of them would have gone into entrepreneurship," Huang says.

Millions of Entrepreneurs

But they did -- millions of them.

Huang has dug into China's Ministry of Agriculture data to show that in 1985, out of the 12 million businesses classified as "town and village enterprises," more than 10 million were privately owned. The conventional view that Chinese TVEs were controlled by local governments is a myth.

So what exactly changed in the relationship between the government and the people to cause this extraordinary surge in rural capitalism? And that, too, just a few years after Mao's Cultural Revolution, when private possession of a book -- let alone a business -- could get a person arrested.

"China then and now does not have well-specified property rights security," Huang says. "But China in the early 1980s moved very far and fast toward establishing security of the proprietor. One should never underestimate the incentive effect of not getting arrested."

Deng Xiaoping

Something about Deng Xiaoping, who led China after Mao's death in 1976, convinced the peasants that changes introduced by him were for real and that life wouldn't revert to being the drag that it was under Mao. ``He was purged three times by Mao and one of his sons was crippled by Mao's red guards,'' Huang writes. ``No other Chinese leader commanded the kind of automatic credibility that he did.''

Some of this is pure speculation. But the theory isn't implausible. Huang's hypothesis may help us better understand contemporary China than reams of analysis of official gross domestic product data churned out by economists.

One of the more shocking conclusions from Huang's analysis is that less than a quarter of the corporate profits in the world's fourth-biggest economy came from domestic private enterprise in 2005. So what happened to Deng's legacy?

Following the 1989 Tiananmen protests, political support for genuine entrepreneurship disappeared in the China of the 1990s. Jiang Zemin and Zhu Rongji preferred growth that was led by foreign capital and occurred in urban centers. For businessmen away from large cities, access to finance dried up just as it was promising to become more liberal.

New Challenges

The current leadership of President Hu Jintao and Premier Wen Jiabao is aware of the challenge that faces them: The gap between rural and urban wages has widened alarmingly; the share of labor in national income has fallen; inequalities between rich coastal provinces and poor landlocked regions have risen.

In the early 1980s, freedom from the fear of incarceration was enough to prompt millions of people to start their own businesses. The institutional changes that are needed now will have to be much more substantive.

As a Chinese company, Lenovo couldn't secure the license to make computers in China, Huang says. It had to come in as a Hong Kong-domiciled ``foreign-invested enterprise.''

Lenovo's success was Chinese entrepreneurship supplemented by the institutional credibility of Hong Kong, where the company, then known as Legend Holdings, raised $29 million in 1994.

Even now, when China has a $3.3 trillion domestic stock market, entrepreneurial Chinese companies are forced to seek finance in Hong Kong and Singapore.

The true capitalist miracle in China is one that's yet to happen.

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