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# **The Sinuous Dragon: Economic Freedom and Economic Growth in China**

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# *The Sinuous Dragon: Economic Freedom and Economic Growth in China*

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## **Abstract**

With sinuous reforms and economic openness over the last four decades, China has enjoyed substantial economic development. Though still a developing country, its GDP per capita has grown over 10% annually, from \$183(US) in 1977 to \$7,590 (US) in 2014. This miracle in economic growth is attributed by some to a series of pro-market policies and reforms. Although the general trend is greater economic freedom, China has experienced brief periods of decreasing or stagnant economic freedom that correspond with slowdowns in the growth rate. In this paper we trace these changes in economic freedom in China and discuss prospects for future improvement.

## **Introduction**

For nearly 40 years China has enjoyed substantial economic development through a freer economic environment and has become the second largest economy in the world. In December of 1978, the Third Plenary Session of the 11th Central Committee of the Communist Party of China (CPC) was held in Beijing. This event is largely recognized as the beginning of China's economic reforms and the opening up of its economy. Before that, the policies of China had largely been antithetical to markets, with China having GDP per capita of only \$70 (US) in 1961. Lackluster growth and social strife was the impetus for Mao Zedong, chairman of the Communist Party of China, to initiate the Cultural Revolution in 1966 (Howden and Zhou, 2015). In 1978, however, incremental economic reforms and the opening of China to foreign markets began, which almost immediately led to growth. However, since the late 1970s, China has enjoyed substantial economic growth, and the average annual growth rate is almost 10%, though the growth has been slowing down in recent years.

Modest reforms in the agricultural sector is a good example of the importance of economic freedom. In 1978, 18 farmers in the village of Xiaogang in the Anhui Province of eastern Middle China pioneered the "household contract responsibility system" whereby remuneration was linked to output, not to the number of hours worked, and local officers and farmers were held responsible for the profits and losses of the operation (Krusekopf, 2002). This was the beginning of introducing some semblance of private property into the agricultural sector, even though land could not officially be owned by individuals. Farmers no longer worked in less productive collective units but rather were responsible for their own contracted lands. As a result, rice, wheat, and corn production increased significantly since 1980 (Howden and Zhou, 2015).

Similarly, in 1979 China started reforming state-owned enterprises (SOEs), which constituted the majority of China's economy (Ping, 2000). Many SOEs were reintegrated and contracted out. This privatization process introduced more vigorous competition and more economic freedom to the economy, contributing to the growth (Allen et al., 2005). While significant reform has occurred, there is still considerable state involvement in utilities and banking. Lardy (2014) estimates that SOEs accounts for one third of GDP and held nearly half of the loans from financial institutes to enterprises. So while private enterprises have been started and become a large part of the economy, many economic decisions are still made collectively (Coase and Wang, 2012).

Given the large role economic freedom has played in improving economic outcomes and well-being (Hall and Lawson, 2014), it is important that the marketization of China continue. In this paper we use the widely-cited *Economic Freedom of the World* (EFW) index by Gwartney et al. (2015) to detail how China has improved in economic freedom since 1980. The EFW index rates and ranks country's based on whether a country's laws and policies impede individual autonomy in

economic affairs. Using third-party data, they place countries on a 0 to 10 scale, with higher values denoting higher levels of economic freedom. For example, China had a score of 3.74 in the EFW in 1980, 4.43 in 1990, 5.78 in 2000, and peaked at 6.25 in 2013. While a large increase in economic freedom, China is still not in the top 100 countries in the world in terms of economic freedom (Gwartney et al., 2015).

Within the overall index, the authors divide economic freedom into five areas: Size of Government, Legal Systems and Property Rights, Sound Money, Freedom to Trade Internationally, and Regulation of Credit, Labor and Business. We will study each of these in turn. We use these areas to organize our discussion of China's changes in economic freedom. Our second section is on size of government, the following section on legal system and property rights, and so on. We conclude with some remarks related to the relationship between political and economic freedom and the opportunities for future economic reforms.

## Size of Government

Size of government is an area in the EFW index because as government gets larger it is substituting public decision-making for private decision-making. For example, as the as government consumption as a percentage of total consumption rises, more decisions are being made collectively. This does not mean that government consumption cannot be used for productive activities, just that it reduces economic freedom.

The size of government area of the EFW index is comprised of four components, one of which is the average of two sub-components. The components and their scores for the size of government Area can be seen in Table 1. For a full description of all the components and sub-components, along with sources, we point the reader to the data appendix of Gwartney et al. (2015). Before delving into the data it is important to note that zeros represent the lowest possible score for that component and empty spaces reflect an absence of data for that component. For example, data on transfers and subsidies as a percentage of GDP was not available for China until 2005.

**Table 1:** China's Scores in the Size of Government Area of the EFW Index, 1980-2013

<i>Year</i>	<i>1980</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>	<i>2013</i>
Government Consumption	5.25	5.73	5.94	6.07	4.28	3.87	3.63	3.71
Transfers and subsidies						8.29	8.29	8.29
Government enterprises and investment	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.00
Top marginal tax rate		6.00	5.00	6.00	6.00	6.00	6.00	6.00
(1)Top marginal income tax rate		6.00	5.00	6.00	6.00	6.00	6.00	6.00
(2)Top marginal income and payroll tax rate							6.00	6.00

Source: Gwartney et al. (2015).

From Table 1 we see that much of the data for China has been constant over the years, with the exception of government consumption as a percentage of total consumption. In 1980, China received a score of 5.25. That had fallen to 3.71 by 2013, reflecting an increase in government consumption relative to private consumption. The large role of SOEs is reflected in the zero score for government enterprises and investment from 1980 to 2010, with a small increase to 2.00 in 2013. The increase in government consumption seems to coincide with the major Chinese tax reform that occurred in 1994 (Mun-Heng and Qian, 2005). The reform made China's tax system more systematic and efficient, leading to a surge in fiscal revenue to the central government. Prior to reform, the central government's share of fiscal revenue was below 33%, but by 1996 it was over 50%. This dramatic increase in government consumption, while reducing economic freedom, reflects the enormous spending on infrastructure that has occurred throughout China over this time period.

The other subarea which has largely not changed but is ripe for improvement is government enterprises and investment.

According to Gwartney et al. (2015), countries receive a zero as long as government investment exceeded 50% of total investment. The zero score prior to 2013 reflects the large role of the Chinese government in the banking and financial sector. While SOEs were propped up during the sub-prime crisis, observers feel that accession to the WTO will hasten reform of SOEs by hardening the budget constraint faced by SOEs (Tian and Xia, 2017).

## Legal System and Property Rights

Though China has slowly increased its economic freedom, it has not occurred in the area of quality of the legal system and protection of property rights. The rule of law and strength of property rights are notoriously difficult to measure and the primary way to do so is through survey data, which largely did not exist prior to 2000. For that reason, Table 2 starts in 2000, when the data used by the EFW in this area came online as the World Bank's *Doing Business* and the World Economic Forum's *Global Competitive Report* began to be regularly published.

**Table 2:** China's Scores in the Legal System and Property Rights Area of the EFW Index, 1980-2013

<i>Year</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>	<i>2013</i>
Judicial independence	3.34	3.92	4.89	4.98
Impartial courts	4.18	4.03	5.21	4.71
Protection of property rights	3.22	4.95	6.74	5.81
Military interference in rule of law and politics	7.34	5.00	5.00	5.00
Integrity of the legal system	6.67	7.50	6.67	5.83
Legal enforcement of contracts		6.73	6.73	6.07
Regulatory restrictions on the sale of real property		8.27	8.27	8.45
Reliability of police		5.08	5.95	5.50
Business costs of crime		4.92	6.77	6.34

Source: Gwartney et al. (2015).

There are nine variables in this area reflecting the role of government in protecting private property and treating individuals equally before the law. There are a couple of important things to note in Table 2. The first is that the score on protection of property rights has improved from 3.22 in 2000 to 5.81 in 2013. While quite an improvement, this is still quite low by international standards. To put it in perspective, in 2013 they scored just above Kuwait on this measure and below Zambia, Brunei Darussalam, and Macedonia. OECD countries like Finland, Norway, and the United Kingdom all have scores above 8.5.

It might seem surprising that regulatory restrictions on the sale of real property is so consistently high. We believe that the incentive for the Chinese government to continue perform well in this area is that it relies on real estate development to stimulate the economy and collect revenues by selling the land use rights (Pan et al., 2015). The remainder of the components of the legal structure and property rights have not changed much over the 2000-2013 time frame. Overall, China's economic freedom in this area is still quite low by international standards, suggesting a lot of room for improvement. In particular, the legal intervention in Chongqing Municipality by Bo Xilai from 2008 to 2012 and his trial in 2012 highlights some of the troubles that China has had with respect to maintaining the rule of law (Self, 2015; Zhou, 2017).

## Sound Money

The sound money area of the EFW index gives higher scores for countries that keep inflation low and stable, do not greatly increase the money supply, and do not place restrictions on foreign currency bank accounts (Table 3). Like most

countries in the world, China has improved its monetary policy with respect to reducing inflation over the past thirty years. In particular, China received only a 7.97 in 1985 on the component for inflation in the most recent year, but a 9.47 score in 2013. Similarly, monetary growth has risen from a 6.00 in 1980 to almost 10.00 in 2013. Freedom to own foreign currency bank account has improved from a zero (not allowed) from 1980-1995 and since 2000 they have scored a 5.00, which indicates that foreign currency bank accounts are available domestically, but not abroad.

**Table 3:** China's Scores in the Sound Money Area of the EFW Index, 1980-2013

<i>Year</i>	<i>1980</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>	<i>2013</i>
Money growth	6.00	8.14	9.18	7.63	8.90	9.05	8.57	9.98
Standard deviation of inflation	9.48	8.64	8.86	8.09	8.63	9.04	8.63	8.58
Inflation: Most recent year	9.24	7.97	8.86	7.36	9.95	9.64	9.34	9.47
Freedom to own foreign currency bank accounts	0.00	0.00	0.00	0.00	5.00	5.00	5.00	5.00

Source: Gwartney et al. (2015).

Despite improvements in this area and the fact that China is doing very well compared to developed countries, there are some points of concern with respect to monetary freedom. First, the inability to hold foreign currency bank accounts abroad. Making that change would give China a 10.00 on that component and an extremely high overall rating in this area. Second, the People's Bank of China has been injecting a lot of liquidity into the economy that may show up in the official inflation statistics or in terms of overvalued assets (Deng et al., 2015). Third, the People's Bank of China is not an independent central bank and political influences might divert the bank from a sound money policy should economic growth slow (Bell, 2013). Fourth, the growth of the shadow banking system in China creates significant financial risk that could lead to the type of systemic risk that contributed to bailouts in the United States (Li et al., 2014). Last but not least, facing the growing depreciation pressure of the Chinese Yuan, the Central Bank has been imposing stricter regulations on buying and exporting foreign currencies in the last months.

### **Freedom to Trade Internationally**

Voluntary exchange is at the core of economic freedom. Individuals should have the right to exchange what they honestly produce with other individuals in society. In practice, while governments sometimes obstruct internal trade, the majority of restrictions on voluntary exchange occur when governments artificially impede exchange with individuals in other countries. Table 4 shows the components of this area of the EFW index for China from 1980 to 2013. As can be seen in the table, China has improved considerably in this area. In fact, it is the primary driver of the country's overall increase in economic freedom.

This area of the EFW index is made up of four components, three of which have sub-components. They main components are: tariffs, regulatory trade barriers, black market exchange rates, and controls of the movement of capital and people. The biggest mover has been tariffs, which rose dramatically following up the opening of the Chinese economy in 1978. China's mean tariff rate was so high in 1980 that it almost received a zero. In 2013 it received a score of 8.02. Similarly, it used to receive a zero on the standard deviation of tariff rates, but now receives a 6.95. Revenue from trade taxes has declined as a percentage, however, that has more to do with the growth of China's trade sector than to other reforms.

The other big mover in the trade area is in black market exchange rates, where China went from a score of 5.00 in 1980 to a perfect 10.00 today. Despite all the improvements in the tariff and black market exchange components, there still remains a lot of room for improvement in the other trade components. In particular, capital controls and freedom of foreigners to visit are among the lowest scores in the world. Many short-term foreign visits are for current or future

exchange purposes and raising the costs of visiting through visa applications reduces the economic freedom of Chinese citizens as it prevents them from interacting with others individuals with whom they would like to interact.

**Table 4:** China's Scores in the Freedom to Trade Internationally Area of the EFW Index, 1980-2013

<i>Year</i>	<i>1980</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>	<i>2013</i>
Tariffs	3.15	2.72	3.16	3.90	7.81	7.96	8.13	8.10
(1)Revenue from trade taxes (% of trade sector)	6.20	3.33	7.53	9.20	8.86	8.81	9.35	9.33
(2)Mean tariff rate	0.10	2.10	1.94	2.50	8.86	8.16	8.08	8.02
(3)Standard deviation of tariff rates			0.00	0.00	5.72	6.91	6.97	6.95
Regulatory trade barriers				4.63	6.01	6.02	6.38	6.34
(1)Non-tariff trade barriers				4.63	4.35	5.14	5.86	5.77
(2)Compliance costs of importing and exporting					7.66	6.91	6.91	6.91
Black market exchange rates	5.00	7.80	0.00	8.60	10.00	10.00	10.00	10.00
Controls of the movement of capital and people	0.00	2.00	5.00	4.91	2.71	2.56	2.19	2.48
(1)Foreign ownership/investment restrictions				4.82	4.66	6.71	6.35	6.25
(2)Capital controls	0.00	2.00	5.00	5.00	0.77	0.77	0.00	0.77
(3)Freedom of foreigners to visit						0.20	0.22	0.42

Source: Gwartney et al. (2015).

A sub-component with almost zero movement is capital controls. In 1980, China received a 0.00 and today it receives a 0.77. In practice, this means that there have been considerable restrictions on the areas where foreign capital can invest. For example, while foreign commercial banks can operate in China, the scope of business is limited. Explicit limitations are placed on foreign ownership levels in those controlling shares strategic industries, since the Party seems uncomfortable with the owning of these industries by foreign capitals (Szamoszegi and Kyle, 2011). Other key sections, like energy industry, communications, infrastructure and etc., are closed to foreign investors and monopolized by SOEs. According to Song et al. (2014), removing capital controls would accelerate productivity growth as well as output growth.

### **Regulation of Credit, Labor, and Business**

China's performance in the area of regulation of credit, labor, and business was poor in the 1970s and 1980s, but has improved since 1990. Table 5 shows the three components of this area of the EFW index for China from 1980 to 2013, all of which have several sub-components. Among the three components, credit market regulations have the largest improvement. In 1990, this component scored zero. By 1995 it had risen to 4.60 and 7.21 in 2013. As noted earlier, foreign restrictions on owning banks are numerous, this is reflected by the low (2.0) score on the ownership of banks sub-component. The remaining two sub-components under credit market regulations, the amount of credit available to the private sector (as a percentage of total credit) and interest rate controls/negative real interest rates, both have been on high levels post 2000: in 2013, the former one scored 9.63, and the second one scored 10.

Business regulations have also been recovering since a drop in the 2000s. China scored a 4.57 in 1995, which increased to 6.25 in 2000. It declined to 3.88 in 2005, however, and had only recovered to its 2000 level in 2013. Administrative requirements and bureaucracy costs are the two main reasons for the 2000s Drop. Meanwhile, most of the other sub-components have been improving over time, which creates a less regulated environment for business in general. Overall, however, the Chinese economy is still highly regulated compared to most other countries in the EFW index, especially components related to the rule of law, like extra payments/bribery/favoritism.

**Table 5: China's Scores in the Regulation of Credit, Labor, and Business Area of the EFW Index, 1980-2013**

<i>Year</i>	<i>1980</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>	<i>2013</i>
Credit market regulations	0.00	0.00	0.00	4.60	6.46	7.06	6.76	7.21
(1)Ownership of banks	0.00	0.00	0.00	0.00	0.00	2.00	2.00	2.00
(2)Private sector credit				9.81	9.39	9.18	9.28	9.63
(3)Interest rate controls/negative real interest rates	0.00	0.00	0.00	4.00	10.00	10.00	9.00	10.00
Labor market regulations			3.16	4.54	4.66	4.98	5.66	5.63
(1)Hiring regulations and minimum wage				5.80	4.37	8.90	8.90	8.90
(2)Hiring and firing regulations			4.30	4.30	5.10	5.27	5.45	5.98
(3)Centralized collective bargaining	4.49	4.49	5.18	6.21	7.67	7.44	7.10	6.40
(4)Hours Regulations				6.42	6.18	6.70	10.00	10.00
(5)Mandated cost of worker dismissal						1.56	2.52	2.52
(6)Conscription	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Business regulations				4.57	6.25	3.88	5.61	6.29
(1)Administrative requirements					7.60	3.96	4.89	5.09
(2)Bureaucracy costs				4.78	5.40	2.00	4.67	4.67
(3)Starting a business				6.05	6.52	8.08	8.42	8.99
(4)Extra payments/bribes/favoritism				2.87	5.49	5.52	5.11	4.99
(5)Licensing restrictions						3.52	5.04	6.92
(6)Tax compliance						0.23	5.54	7.07

Source: Gwartney et al. (2015).

Labor market regulations also have slowly improved over time. Overall, China's score on the labor market regulations component of the EFW index has increased from 3.16 in 1990 to 4.98 in 2005 to 5.63 in 2013. One reason for the slow improvement of this component is China's new labor contract law implemented in 2008 (Li and Freeman, 2015). Cheung (2008) argues that the hiring and firing regulations of this new labor law restrict the freedom of employers to freely hire and fire employees and the minimum wage restricts economic freedom too. Similarly, the required two years of military conscription is a large constraint on the labor of young Chinese workers and why the country receives a zero for that sub-component. While still fairly low, there is a bright spot. Hours regulations have improved to a 10.00 from a 6.42, suggesting a significant loosening on restrictions on the number of hours individuals can work.

### Concluding Thoughts

China's economic miracle since late the 1970s is promoted by its economic reform and opening up, which has enabled the people to be more and more involved in the market process of division of labor, nationally and internationally. China is evidence that a little bit of economic freedom goes a long way. However, economic freedom has not improved much in the last fifteen years, which has the potential to stifle continued economic progress. In other words, the reform dividend has started to disappear.

In addition, economic freedom is the foundation of political freedom, and political freedom, in turn, promotes economic freedom and economic growth. The two complement each other, and jointly promote the development of social civilization and overall development. According to "Hayek-Friedman hypothesis", economic freedom can exist in both politically free and unfree societies, while those which are not economically free are generally not politically free (Lawson and Clark, 2010). Although there have been societies which are not economically free but politically free, most of them have diverged to other combinations or are currently on the path of divergence. The politically free but not economically

free society is considered as an unstable equilibrium (Hayek, 1944; Friedman, 1962). China's path in the last four decades has not been a violation of the "Hayek-Friedman hypothesis" path. Its political freedom is still at an extremely low level.

It is difficult to forecast China's path. Perhaps the path of Taiwan, which had both economic and political reforms in 1980s after its economic growth for decades, will be followed by mainland China, though this mirror with the prevalence of populism and inefficiency in politics is still not a perfect example. However, the history of the last forty years does tell that part of the chains constraining this sinuous dragon have been removed in short order. It is not too bold to expect another round of significant growth if more chains are released.

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