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THE FAILURE OF THE FREE MARKET? AN ANALYSIS OF THE VIABILITY OF STATE CAPITALISM AS AN ECONOMIC GROWTH MODEL

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Abstract:

In this thesis, I analyze State Capitalism to determine if it is a viable alternative to the free market as an economic growth model, using China as a case study. I analyze China's development from the death of Mao Zedong to the present, paying particular attention to how China was able to implement reforms and transition from the traditional model to the various more liberal models during the later stages of its growth. I focus on the balance between consumption and investment, factor productivity, fiscal decentralization, financial market reforms, and political reforms. In the case study, I argue that while China has successfully reformed in some areas, positioning it to maintain its economic growth, it has failed to address all of its economic issues, creating problems that will surely become a hindrance to development in the future. I find that while State Capitalism can serve as a viable growth model during the early stages of a country's development, the success of the model long-term depends on a country's ability to institute various reforms that are needed throughout economic growth. Due to the varying nature of the issues that arise during development, State Capitalism becomes more nuanced during the later stages of development, with each country creating specific models that cater to their individual economic issues.

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Chapter 1: Introduction

The final chapter of Ian Bremmer's The End of the Free Market: Who Wins the War between States and Corporations? begins with a quote from anarcho-capitalist Murray Rothbard stating "I'm very optimistic about the future of free-market capitalism. I'm not optimistic about the future of state-capitalism-or rather I am optimistic, because I think it will eventually come to an end".[1] The chapter, entitled "Meeting the Challenge", develops the idea that while state-capitalism will be around for decades, its fate is sealed as a failed economic model as free-market capitalism continues to outlast any of its competitors. State capitalism has come to the forefront of developmental economics in the past few decades largely due to arguments over the rise of China and the subsequent decline of the US. But what a lot of scholarly literature fails to do is go one step further to look at the model that China has created and determine whether what they have is a one-off success story or a more successful model that other developing countries can now adopt if they want to compete on a global stage.

There are effectively two sides to this argument: that State Capitalism is a viable economic model capable of challenging free-market policies or that it is a model doomed to fail as Free-Market Capitalism remains as the only model for sustainable economic growth. In the first view, the era of the free-market is over as national governments pick winners that can out-compete their competitors. With the state acting as the primary economic driver, countries can achieve unmatched growth relative to the free-market, allowing them to gain both economic and political power. What these scholars predict is not a complete overhaul of the global economic system, but rather a world in which state capitalist economies continue to gain economic ground

[1] Ian Bremmer, *The End of the Free Market: Who Wins the War between States and Corporations?* (New York: Portfolio, 2010): 171.

at the expense of free-market economies. The other side of the argument maintains the idea that Free-Market Capitalism is the only model capable of maintaining economic growth in the long-term. While State Capitalist countries have experienced unmatched growth in the past decade, that level of growth is unsustainable due to government bureaucracy, inefficiency, and corruption. Eventually, existing state capitalist countries will have to concede to free-market policies while new developing countries choose liberal economies over governed markets, leading to the ultimate death of State Capitalism as an economic model.

With a few exceptions, the majority of existing literature on the subject faults due to one of two problems: the timing of their arguments and their analysis of the transition from State Capitalism to the Free Market. Most of the predictions about global hegemony and the rise of State Capitalism were made between 2008 and 2011, when the largest free-market economy was in the midst of one of its historically worst economic crises. During that time, the economic statistics did present an argument that free-markets could be on the decline as the US, and every other country in the globalized economy, were suffering while China and other state capitalist economies were not hit as hard. But what these arguments do is take advantage of an economic downturn due to unregulated markets and take it the polar extreme, arguing that a government-controlled economy is more effective overall. The other side of the argument notes this flaw in this analysis, but takes it too extreme as well, failing to note China's economic success and the rise of successful state capitalist policies in developing countries.

In addition, the argument that a transition from State Capitalism to the free market is necessary in order to achieve sustainable growth skips over or makes blanket statements about the transition process. In the cases of authoritarian governments, prior analysis simply states that reform is needed in order to transition into the long run. While offering no tangible means of performing such a transition, they instead make the blanket statement that political and economic reform is required in order to make the model effective. With democratic governments, while they argue that the possibility of reform is greater, they also argue implementation of State Capitalism is impossible in the first place given the type of government needed to exert control over the economy in the first place. So in this analysis State Capitalism is left as a successful short-run growth model with no means of making it effective in the long term, leaving it a limbo state where any country that uses the model is prescribed successful growth in the short run but failure later.

My hypothesis falls in the middle of the spectrum between these two sides. I argue that State Capitalism can create effective economic growth, but that the success of the model in the long run depends on a country's ability to reform and solve the problems that arise during economic development. While it is theoretically possible for a democratic government to institute State Capitalism, the model only works as a practical solution for right-wing governments that have the ability to extend control over an economy, then institute political and economic reforms in the long run. Because the problems that arise and the reforms that are needed are unique to each country, while State Capitalism can serve as a good growth model in the beginning, the way that a country adapts to its development and the model that it adopts in the long run is not defined yet and instead depends on the country.

Exploring the rise of State Capitalism is vital for policymaking in western, free-market economies. Should my hypothesis be incorrect, then we are either amidst the next great global shift from the free-market to the governed market or simply experiencing the next failed challenge to liberal economic policy. If proponents of the rise of State Capitalism are correct, then we are due for a global shift as western, free-market economies continue their decline while developing State Capitalist nations come to the forefront as economic hegemons. Eventually, as countries begin to close their doors, the world becomes sectioned off and globalization begins to reverse. However, if State Capitalism is in fact a one-off success, then western economies can outlast this challenge by maintaining the same neoliberal economic policies that have created the current global system. While I will not be presenting an analysis of the proper response by western economies to the rise of State Capitalism, the argument I do present will serve as a basis to do further research into how the current economic order can use its advantageous position to welcome developing countries into the current global system. What I argue is more likely is that countries will adopt this model as way to jump start growth in the short-term to spur development, but as they realize the inefficiencies in the model, will eventually adopt more liberal economic policies as they join the more integrated, globalized economic order.

In the first section of the thesis, I set out to define State Capitalism and determine where exactly the line is drawn between the nuanced forms that I will present in my case study. I provide a definition for Free-Market Capitalism and a benchmark for economic dominance to see where policies have been effective and where they have fallen short. I also present an evaluation of scholarly literature as a basis for my analysis, exploring various theories on how the model works and identifying how other countries have adapted state capitalist policies. I finish with an analysis of my economic measurements and offer an explanation as to why I have chosen those indicators specifically as being vital to long-term growth.

In Chapters 5 and 6, I present a case study of China to test my hypothesis. First, I go into the history of State Capitalism in China and how it arose from market-governing Marxist policies in the Mao era. Based on the levels of government intervention in the economy and economic growth, I map out a progression of the various models used in China, dividing its economic development into sections based on each model. I point out a path of transition from the traditional to the majority investor forms, aiming to show if further development is plausible. I also go into economic analysis, where I explore the growth that correlates with each section. Essentially, starting with the traditional model, I analyze each form of State Capitalism in China and how economic growth changed with their progression. Here, I argue that China successfully maintained short-term development under the traditional model, characterized by unmatched GDP growth and an accumulation of foreign assets. As China transitioned from the traditional to the majority investor model, the growth continued due to economic liberalization. However, due to imbalanced growth, certain reforms are needed in order for that growth to continue. Using a current analysis of economic growth, including GDP, wealth gap, Foreign Direct Investment, factor productivity, consumption, and investment, I will point out the flaws in China's current development, arguing that China needs to balance consumption and investment, institute fiscal decentralization, and introduce financial market and political reforms in order to maintain its long-term growth.

Finally, I will provide an analysis of China's ability to institute the various reforms. Due to the fact that problems arise with the traditional form, I hypothesize here that while China has transitioned to somewhat more liberal economic models, another degree of reform is necessary to sustain their growth. In order for State Capitalism to be considered a viable model at all, there needs to be the ability to institute such reforms where the model originally fails. Using data on consumption versus investment, factor productivity, corruption, tax revenue, and private capital accumulation, I aim to empirically measure how successful China has been in implementing these reforms. While I argue that there is the ability to introduce such reforms, China has failed in its attempts due to its inability to fully rebalance consumption and investment, implement fiscal decentralization and liberalize politically. But because it made progress in all of these areas, it is likely that China will continue to be a dominant economic power in the near future. In order for it to continue its economic growth in long term, however, it must continue to implement changes in the both the political and economic realms.

I will then take the results of my case study and analyze what that means for the State Capitalist model as a whole. With a high level of government intervention in the economy, especially in key industries, a country can obtain high growth at first. But due to the limitations of government, including bureaucracy, inefficiency, and corruption and greed, in the long-term countries cannot sustain the same level of growth using solely the traditional model. Only when countries transition to the more liberal forms of State Capitalism can they continue their rise to be able to participate in the international system. Since the traditional model is dependent on a powerful, centralized government with access to key industries, there are political limitations that make it more difficult for democratic countries to implement this model, thus making a more practical model for right-wing governments that have the ability to effectively implement the first stage in this development. Finally, I finish with where State Capitalism and China land in the overall spectrum of economic growth. I argue that while the state capitalist model can be adopted by developing countries as a successful means of creating development, the problems that arise and the reforms that are needed are unique. So, while there is a defined model for short-term growth and a progression that needs to be followed in order to continue that growth, ultimately the long-term model is not defined yet, and instead countries develop their own nuanced forms of State Capitalism based on the problems that arise during their growth.

Chapter 2

Review and Evaluation of Scholarly Literature

The study of State Capitalism is a growing topic, encompassing many viewpoints on the reasons for a government intervening in an economy, the effectiveness of a government doing so, and the debate over the consequences for Free-Market Capitalism. There has been extensive research on the subject, ranging from direct analysis of state capitalist models to more indirect discussions of the topic when examining the economic rise of China and the Asian Tigers. The existing writing on the topic can be categorized into three categories based on the reason behind the effectiveness of State Capitalism: the political view, the industrial view, and the path-dependence view. This literature review seeks to explore these three categories, paying particular attention to the way in which each author applies their model to which specific cases. After a review of each argument, I follow with a closer examination of the research of Aldo Musacchio and Sergio G. Lazzarini, who take a unique approach to the state capitalist model, applying three different forms of the model with varying degrees of government intervention.

Before getting into each argument, I will explain the general points of each argument and how they apply to the economic model. The political view takes a more critical view of the governments practicing State Capitalism, arguing that the model arises solely as a method for government to accomplish its political objectives. By intervening heavily in the economy, a government can use its economic power as another arm to achieve political goals at the expense of both national welfare and economic growth. The industrial argument views the rise of State Capitalism as a necessity caused by market failures. Due to the comparative advantages of other countries and the huge economies of scale that arise out of industrialization, firms in developing markets are unable to compete internationally against larger, more efficient companies. Because of this failure in the merging market, the government is forced to step in to direct the economy correctly so that the market runs efficiently. Finally, the path-dependence model views the rise of this new model as a product of the complex relationship between the political and economic spheres. As politics and economics become more intertwined, the government extends its reach over the economy until eventually political and economic goals are aligned, priming the conditions for a government-controlled economy.

The Political View

I begin with perhaps the most cynical of all the views with the political perspective. This argument, supported primarily by Ian Bremmer, is more popular among political realists who predict that the great battle of the 21st century is one pitting free markets against those that are state-run. In his work, Bremmer uses the political view to analyze the rise of State Capitalism after the 2008 financial crisis, defining the model as, "bureaucratically engineered capitalism in which the state dominates markets for political gain"[2]. He begins with an analysis of the history of State Capitalism, but spends the majority of his work analyzing how the model has risen in countries with more authoritarian governments than with liberal democracies. He presents an overall analysis of the model and the global implications for free-market economies and political economic policy in general. But rather than focus on an argument about the effectiveness of the model, he takes more of a roll in identifying where and how the model has developed and what that means for Western powers. He concludes that while it is ultimately an inferior model to Free-Market Capitalism, there are nonetheless some advantages that will cause State Capitalism to persist for at least the next few decades.

[2] Bremmer, 23.

Based on his analysis in a number of cases, Bremmer arrives at the conclusion that State Capitalism is inherently incompatible with free markets. Where he falls under the political view is that he argues that political goals are the main interests behind the rise of this model. While every country has state capitalist elements, it becomes a matter of where countries fall on the spectrum and if they meet the model to be described as full state capitalist. However, that does not mean that it is an effective growth model as it is not a series of steps to help rebuild an economy, but a long-term plan meant to design the economy in the state's favor. The ulterior political motives as well as the inefficiency and corruption of government make State Capitalism an ineffective long-term growth model.[3] Because the model is inherently designed to benefit political leaders, it does not increase social welfare nor create sustainable economic prosperity. Globalization had created a more integrated global economy so that countries need the global free market to create sustained growth.[4] While he acknowledges the unmatched growth that many state capitalist countries have achieved in recent decades, he argues that this is so as a result of stages of liberalization in their economies, which are slowly transitioning to free market policies. Eventually in order to continue the same level of growth, these countries would need to continue to privatize industries and reform institutions until eventually they arrive at a free market model that will give them the long-term sustainable growth.

Nonetheless, Bremmer does point out that State Capitalism is not a fading model that brought success in special cases where exogenous factors led to economic growth. But rather there are some advantages to the model, among them being eliminating the profit motive for firms and gaining access to repressive regimes where foreign multinationals are restricted.[5] Due to the financial crisis, there has been an increased cloud of skepticism over Free-Market

[3] Bremmer, 172-173.
[4] Bremmer, 175.
[5] Bremmer, 61.

Capitalism. Because countries with a higher degree of state control were not hit as hard by the financial crisis, the crisis has reinforced State Capitalism and undermined the free market, meaning that, at least for the near future, the model will rule as it is the only effective means for political leaders to protect against the excess of the free market.[6] So as countries begin to erect trade barriers and increase protectionism, State Capitalism becomes the next choice for political leaders looking to take advantage of the economic situation in order to solidify their power.[7] While eventually, free market policies will prevail as the only viable means to create sustainable economic growth, the near future will be characterized by a rise in state capitalist models and an increase in protectionism from free market economies, which will only serve to make State Capitalism more effective.

Bremmer does an effective job of pointing out the flaws in State Capitalism while accounting for the fact that indicators point to its survival in the near future. However, due to the time period in which he wrote his argument and due to his definition of the model, Bremmer's work, and the political view in general, suffer from gaps where a more wholesome argument can be made. It has been almost a decade since Bremmer presented his argument, which was during the recovery from one of the worst economic crises in the Western world. Since that time, free market economies have had more time to recover from the financial crisis. Due to the time period for his argument, the economic statistics and trends tend to favor the state capitalist countries, who were not hit as hard as the more integrated and globalized free market countries. Using data from the financial crisis skews the results of an investigation. Pointing to the rising numbers of state capitalist countries and the falling statistics of free market countries would make any argument for State Capitalism more legitimate. Essentially, Bremmer falls victim to

[6] Bremmer 178.
[7] Ibid.

the trend of the time, namely predicting a grand global shift in hegemony from liberal economies to state-run economies when in fact accounting for the current growth numbers of free market economies paints a very different picture.

Furthermore, Bremmer limits his argument to what I label the traditional form of State Capitalism. In his definition, Bremmer focuses solely on the government as the direct manipulator of an economy for political purposes, failing to account for nuances in the model. While he does mention the use of sovereign wealth funds and national champions, he draws a line that I believe does not encompass how State Capitalism has developed in recent decades with models where the government is simply a majority or minority investor in key sectors and not an economic tyrant. This is what leads him to label Brazil as not a state capitalist country, despite Brazil's adherence to state capitalist models throughout the 1970s and 1980s. By focusing only on political objectives, Bremmer fails to account for the successes that countries have had in creating successful short-term growth where free market policies would have failed. He argues that political leaders use the model solely for political gain when in fact, State Capitalism has been a successful way for governments to incubate underdeveloped industries to prepare them to compete on the national scale. I argue that Bremmer takes too limited a view of State Capitalism in a skewed time period, turning his argument into a cynical approach where political cronyism is the sole reason for the rise of the model.

The Industrial View

With the Industrial View on State Capitalism, existing research argues that the model arises as a result of market failures that prompt the government to intervene and provide economic support where those failures occur. Supported primarily by the work of Christopher

McNally this view looks at State Capitalism as a necessary step for developing countries in order to be able to compete later on a global scale. Here, industrialists argue that what really makes an economy effective is how efficiently a country is able to allocate its resources. When a country is in the early stages of development, there exists an inefficiency where firms cannot allocate their resources as effectively or access capital as readily as developed firms that benefit from economies of scale and globalization. Due to the nature of the current global economy, countries are unable to escape globalization and integration if they want to achieve sustainable growth.[8] But with inefficient firms that are unable to compete with larger existing firms, markets in developing countries fail, causing the government to step in and direct the economy more efficiently until firms are strong enough to compete on a global scale.

Christopher McNally serves as the primary developer of this model in his work on State Capitalism in China. In this case study, he begins with the history of Communism and how through gradual liberalization of the economy, China arrived at a state capitalist model in the early 1990s. In his analysis of Sino-Capitalism, McNally looks into the unique way in which China combined a top-down state-run economic model with bottom-up private capital accumulation to create unmatched growth in the 21st century. While he focuses solely on China in developing his model, his conclusions can be generalized and drawn out to other examples of emerging markets closing off and incubating key industries. Following his analysis of Chinese growth, McNally arrives at the conclusion that State Capitalism can be a logistical way by which weaker players in the global system can withstand the pressure from outside sources to develop effectively in key industries.[9] Essentially what McNally argues is that the timing of when a

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[8] Michael Cox, "Power Shifts, Economic Change and the Decline of the West?," *International Relations* 26, no. 4 (2012): 378.
[9] Christopher McNally. "Sino-Capitalism: China's Reemergence and the International Political Economy," *World Politics* 64, no. 4, (2012): 768.

country arrives on the global scale will affect which economic model it pursues. We see an increasing trend of developing countries moving away from traditional free market policies, and McNally argues that it is due to the fact that State Capitalism has the ability to strengthen key industries.[10] Due to the existing globalized system saturated with large companies with large economies of scale and easy access to capital, developing economies are more likely to adopt the state capitalist model so that they can later compete with already developed nations.[11] So in the industrial case where the government serves as a solution for market failures, State Capitalism arises as an effective model for emerging markets preparing to compete on the global scale.

McNally and the Industrial View do bring a unique perspective to the debate over State Capitalism by treating the question not as one of political cronyism, but one of necessity in the market. It is in this view where we begin to see that State Capitalism can serve as an effective short-term growth model rather than the more cynical view of an economic system designed to benefit the political elite. However, this model still suffers from gaps, specifically in the cases in which the model is applied and the limitations of its scope. First, the Industrial Approach focuses too much on developed economies and success stories and pays almost no attention to those economies during their developmental stages. In existing research using the Industrial View, scholars focus primarily on the countries that successfully implemented the state-run system, namely China and the Asian Tigers. What they fail to do is account for the degree of liberalization that occurred in these countries. By avoiding this developmental stage, the Industrial View paints a picture of a binary model to juxtapose against free markets. Because the whole argument is based on how currently developing countries are more effective using a state capitalist model to be able to develop efficiently, it would be more thorough to reference the

[10] McNally, 753.
[11] McNally, 755.

developmental stages of emerging markets and apply the nuanced models there to test their hypothesis more completely.

In addition, the Industrial View limits its scope to talking about solely economic factors and fails to take into account the political reform required to transition from State Capitalism to more liberal policies. In many of the cases that the Industrial View discusses, authoritarian governments already existed, making it easier to extend political control over the economic sector. However, by omitting the process of political transition needed to achieve the other models, the argument fails to account for the challenge in getting right-wing governments to voluntarily give up power over the economy. So if an authoritarian government is required to implement the first policies, but a more liberal government is needed in order to transition to the other state capitalist forms, then the political transition becomes essential to the model. Furthermore, the model skips over the economic reform that state capitalist countries had to implement to create effective policies once industrialization was reached. In order to move to the more liberal policies needed for long-term growth, these countries had to go through significant reform periods, characterized by privatization of industries and the creation of independent institutions to monitor the economy. When the model is so reliant on authoritarian governments, there is gap in determining how a more right-wing government would be willing to give up power to move towards liberal market reform. Without discussing political issues, the model is incomplete in determining 1) how a democratic country could institute State Capitalism and 2) how a state capitalist country can transition to a freer economy politically as well as economically.

The Path-Dependence View

In contrast to the arguments made by the Political and Industrial Views, the Path-Dependence View is more of an observation on the systemic conditions that led to the rise of State Capitalism. Supported primarily by Robert Wade and his analysis of the Asian Tigers, the Path-Dependence View does not take a position in saying whether State Capitalism or Free-Market Capitalism is a better economic model, but rather argues that there is a natural progression from one to the other.

In his work, Wade describes three models: the free market, the simulated market, and the governed market. Because of the complex relationship between political and economic policy, there exist elements of all three types of markets in every case. By applying these three models to the rise of the Asian Tigers, Wade describes the natural progression that occurs for the economic development of countries based on three factors. The first is the same argument that the Industrial View uses, where emerging markets cannot compete with the larger and more efficient companies. Due to huge economies of scale and access to capital, State Capitalism serves as a better model to incubate industries. But as countries develop, the state-run model begins to be more of an inhibitor, thus prompting the country to switch to more liberal policies to achieve long-term growth.[12] The second factor is the role that external market forces play in economic development. In the case of the Asian Tigers, the US played a huge role in their economic development for security reasons. Because these countries lie on the edge of the pacific horizon for the US, the US essentially invited these countries to industrialize by creating opportunity for low-cost industrial production.[13] With such a strong outside force, it made government intervention harder and made the transition to free market policies easier. Finally, Wade describes the role of the different phases of the global economy. When the economy was in an

[12] Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization.* (New York: Princeton University Press, 1990): 342.
[13] Wade, 346.

expansionary phase during the late 20th century, state capitalist policies were more effective because countries could easily foster growth within their borders before turning outwards to globalize.[14] But because the market has steadily progressed to the point that it is no longer in an expansionary phase, free market policies become more effective due to increased volatility of markets as a result of deregulation and internationalization.[15] The conclusion that Wade arrives at is that neither model is better than the other. Such a conclusion is not possible when one model naturally leads into the other. But rather the economic growth of the Asian Tigers can be attributed to the combination of models combined with external factors.

The Path-Dependence View does an effective job of combining the Political and Industrial viewpoints, which does prevent it from suffering from the same gaps that those models do. But nonetheless, this model still does not completely address the question, specifically in its discussion of how countries can transition from State Capitalism politically and what happens when countries do not have the benefit of outside forces pushing them along. The model goes into great detail in describing how countries can transition from State Capitalism to more liberal policies economically, but glosses over the difficulty in a government doing the same transition politically. This is a similar problem to the Industrial View model in its lack of addressing political factors. If the government of the country is authoritarian, the model makes a grand assumption that the government would voluntarily give up its power when moving toward the free market. I argue that the likelihood of that happening is rather slim given the history of authoritarian governments relinquishing power. Again, the problem becomes that an authoritarian government is required for the first stages of development, but a more liberal government is needed to facilitate political and economic reforms. Thus, omitting a clear process

[14] Ibid.
[15] Ibid.

of political transition leaves gaps in the argument. In addition, the theory, and more specifically Wade, also fails to address how instrumental the US was in the economic growth of the Asian Tigers. Because such an outside force is not available to a country that is not a strategic ally of a powerful nation, the theory leaves a gap when there are no positive external forces acting on a market. Thus, by failing to address this transition, the model leaves questions unanswered in how a country can effectively implement marketization without outside help or without suffering political setbacks.

Variations of State Capitalism

While all of the above theories help to paint a comprehensive picture of the perspectives regarding the rise of State Capitalism, only one piece that I have found really focuses on the nuances of the model and how they can be brought into this debate. Aldo Mussachio and Sergio G. Lazzarini use Brazil as a case study for exploring the different forms of State Capitalism and what conditions make each model favorable. While Mussachio and Lazzarini describe three models of State Capitalism (entrepreneur, majority investor, and minority investor) I will focus only on the last two as the entrepreneur can be equated to the traditional form described above.

In their analysis of Brazil as a state capitalist country, Mussachio and Lazzarini describe a general progression from the entrepreneur model to the minority investor model. Noting that the traditional model of State Capitalism has been for the most part ineffective, they focus more on the variations of the model. In doing so, they propose the possibility that countries adopt these nuanced forms of State Capitalism as an alternative solution to free market policies depending on their form of government.[16] The more right-wing the government is, the more likely the

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[16] Aldo Musacchio and Sergio G. Lazzarini, *Reinventing State Capitalism, Leviathan in Business, Brazil and Beyond* (Berlin, Boston: Harvard University Press, 2014), https://doi.org/10.4159/harvard.9780674419582.

entrepreneur or majority investor models will work. Contrarily, the more democratic the government is, the greater the possibility of the minority investor model working. With the majority investor model, the government serves as a controlling shareholder of key national champions, thus limiting the mismanagement issues that arrive from government leadership.[17] If the government moves further towards liberalization, we arrive at the minority investor model, where the government acts through sovereign wealth funds and development banks as a minority shareholder, though often controlling decision-making with so-called "golden shares".[18] By acting as a majority or minority investor, Mussachio and Lazzarini find that the problems that arise from State Capitalism are limited and the transition to free market policies is easier and more effective. But while they present these models as viable alternatives to Free-Market Capitalism, they do acknowledge that they are second-best solutions as they suffer from the same issues that the entrepreneur model suffers from, such as corruption and government inefficiency.[19] Nonetheless, Mussachio and Lazzarini present a unique view on the State Capitalism debate by identifying these nuanced forms that governments can adopt without needing to go the full extent to the traditional model.

Mussachio and Lazzrini's research is compelling in many ways, but still leaves some key questions unanswered. They do a successful job of bringing these nuanced forms of State Capitalism into the debate, opening the possibility that democratic countries can adopt the model to achieve economic growth. But the gaps in their research do leave the opportunity open to complete the model and extend their conclusions to other cases and other arguments for state intervention in the market. First, they only focus on the development of Brazil which, as noted above, is a failed example of a country instituting State Capitalism. Based solely on this work,

[17] Musacchio and Lazzarini, 8.
[18] Musacchio and Lazzarini, 8-9.
[19] Musacchio and Lazzarini 287-289.

we would be led to conclude that the majority or minority investor models do not work if the one case that the authors use failed. However, in looking at this model in other countries, we see that there are other cases adopting these various forms, usually in combination with the traditional model, as in Russia. In addition, the line that Mussachio and Lazzarini draw between forms, specifically between the minority investor and free market models, can sometimes be blurry. In the definition used of State Capitalism, the government must act as the primary economic actor. However, in the minority model, there are times in their work where the Brazilian government was not acting as a primary force, but serving more of a secondary role in development banks. This would violate the State Capitalism definition, meaning that in fact the government moved more towards a free market, essentially serving as a counterexample to the effectiveness of the model. Finally, the model also suffers from the same political setbacks that exists in the prior models in glossing over the difficulty in political reform. Again, Mussachio and Lazzarini argue that political and economic reform must occur simultaneously in order to have the smooth progression of models in the long-term. But as mentioned above, the likelihood of authoritarian governments voluntarily giving up power or the difficulty in instituting political changes in democratic countries without public pushback limit the ability to transition between models. Essentially what this calls for is not only further exploration into the nuanced forms of State Capitalism and its application to other cases, but also further research on the models with particular focus on the form of government and the economic as well as the political transition.

My Niche

There has been a fair amount of research done into State Capitalism as a viable economic model, but there are gaps, specifically in which variations of the model are used and in providing a long-term analysis of transitioning to the long run. In addition, there is a lack of analysis on where China and its model fit into the existing picture. First, the majority of the published material on this subject, especially the pieces on China, was written during the 2008 financial crisis. So using data from this time tips the scale towards State Capitalist countries, who were not hit as hard as liberal economies due to the fact they were more closed off and thus less affected by international crisis. So the picture that these authors paint is of a zero-sum economic game where State Capitalism is fundamentally incompatible with free market policies. They argue that the reason that State Capitalism will stay around for the near future is because of its ability to empower right-wing governments for political gain.

Next is the problem of bringing in the more nuanced forms of State Capitalism. Here, authors suffer from one of two issues: they either discuss the different state capitalist models, but fail to apply those models to authoritarian governments or they discuss the strictly traditional form of State Capitalism and create a binary model to compare with the free market. With the first issue, authors like Musacchio and Lazzarini bring in the idea of a transition from one model to another, but explore the results only in a more democratic nation. By looking solely at Brazil, a failed example of State Capitalism, this analysis does not address a significant factor in other government-run economies, the authoritarian government. The other issue arises primarily in the Industrial and Political Views. Authors here treat State Capitalism as a one-off choice that a country can follow instead of Free Market Capitalism. This creates a binary model and fails to account for the more nuanced forms with the possibility of transition between the various models. What this does is close the door on possible interpretations of the model as a successful economic growth strategy that can align with a developing country's interests.

Furthermore, they fail to provide a long-term solution for State Capitalism given the need to transition in the long run. In most of the cases described above, State Capitalism is presented as either an ineffective model or a backup policy where the free market has failed. While State Capitalism has seen success stories in the Asian Tigers and Russia, they argue that in the long run the key to create sustainable growth is the transition to more liberal forms of State Capitalism or the free market. The reason that the Asian Tigers were so successful is that they did not stay with the traditional model and instead moved to more mixed models combining both state capitalist and free market policies. In addition, countries have been punished for failing to make this transition. In Russia, for example, the lack of switching to a more liberal model and the rigidity of the government in instituting economic policy led to a failure to diversify the economy. This caused growth to slow and fall behind the rest of the developed world. Thus, the only way that State Capitalism can work is if there is an effective way for a country to transition from a government-led economy to the free market. However, within the analysis of the more nuanced forms, authors fail to account for the primary role that liberalization and privatization play in the economic growth of these countries. Many of these countries began with traditional state capitalist models, only to slowly transition to a more moderate form of the model to continue their economic growth. If State Capitalism is to be an effective growth model at all, then there needs to be a concrete argument for the possibility of transition via political and economic liberalization.

Finally, they fail to define if China is actually using a different growth model than what has been established by the Asian Tigers and the Soviet Union. The common theme amongst the various authors I analyzed is that based on existing models used by the Asian Tigers, Russia, and Brazil, China must follow a certain path in order to create sustainable growth. This begs the question: is China actually creating a new growth model or is it simply following the existing models created by other state capitalist countries? Authors such as Paul Krugman and Michael Pettis have argued that China's growth is nothing new, but their arguments do not delve into State Capitalism and instead focus on China specifically. If China is simply following another model, then we can easily determine where China's growth is failing, how China needs to reform, and how China's growth will pan out based on how successful it is in implementing such reforms. But, as I argue, if China is not following another model, then we have one of two cases: China has either created a new growth model or perhaps there is no set model yet. This is similar to what economist Dani Rodrik has argued in saying that there is not definitive way to create effective economic growth and instead individual countries cater to individual problems and create second-best solutions.[20]

My niche in this argument is to synthesize the different points of view presented, bring in modern data, and define a place for State Capitalism and China in the spectrum of economic growth. With my argument, I take the more nuanced forms of State Capitalism and test them at various stages of development in China in order to provide a long-term place for State Capitalism in the economic growth model. That way I can address all of the issues that are left out by other arguments (lack of analysis of liberalization, skewed economic data from the financial crisis, and defining a place for China's model). By giving an update on the economic growth after the recovery from the financial crisis, I avoid the skewed data from the crisis, where economic data supported the argument for State Capitalism. In tracking the forms of State Capitalism in China and the political and economic reforms that came with them, I can draw a correlation between the levels of economic development and the progression of models that led to such development, showing if in fact China can make the necessary transition. Finally, based

[20] Dani Rodrik. "Second-Best Institutions." National Bureau of Economic Research, June 2008, p. 10.

on the fact that the gaps in China's growth are different from those suffered by the Asian Tigers, Russia, or Brazil, I show that while State Capitalism is an established model where China is doing nothing new, the problems that arise and the reforms that are needed are unique to each country, requiring a different model for growth in each case.

Chapter 3

Methodology: Measuring Economic Success and the Ability to Reform

To evaluate the viability of State Capitalism as an alternative to free market policies, I have put forth three hypotheses formulated to support my overall argument: that State Capitalism can be a viable alternative to the free market, but that both political and economic reforms are needed in order to make the system successful in the long-run. I use China as a case study due to its increasing position in the global economic community as well as its clear progression through the different state-led models. To evaluate these hypotheses, I break down the analysis into essentially three parts. I first employ both qualitative and quantitative analyses in my work to determine the baseline form of State Capitalism in China and how it has progressed from that original form to its current form. I then use a quantitative analysis of China's economic growth to draw conclusions about the effectiveness of each model, identifying where adjustments are needed. I end my analysis with a measurement of the degree of political and economic reform to determine if there is a logical path to a long-run form of State Capitalism.

Measuring Forms of State Capitalism

The first question I address is how a country determines which model of State Capitalism it will adopt, which leads me to my first hypothesis. I propose that the model that is most likely to develop is a direct result of the system of government and the economic model a country used prior to adopting State Capitalism. Before going into how I am going to test each hypothesis, I must take a moment to explicitly define each model.

The first model, which I label the traditional model, is the most generic form when offering a comparison between government-led and market-led economies. The model is defined as a bureaucratically engineered system in which the state plays the role of leading economic actor, operating with direct control and ownership over firms and using the market primarily to achieve its own objectives. Here, the government directly intervenes in the economy through the use of state-owned enterprises (SOEs), firms that are characterized by limited autonomy and transparency. In the majority investor model, the government intervenes in the economy directly by being the majority shareholder in publicly traded SOEs or indirectly through the use of sovereign wealth funds (SWFs) or development banks that in turn take majority positions in key companies. The SOEs of this model are characterized by more financial autonomy, professional management, and audits by professional accounting firms.[21] The minority investor model is characterized by even more liberalization to the point where this model becomes a hybrid form of State Capitalism, where the firm is privately managed, but where the government acts as a minority shareholder and supports the firm financially. Finally, we arrive at Free Market Capitalism, characterized by the private ownership of the means of production, freedom of economic exchange, competitive markets, and limited government intervention.

To empirically determine which category China falls under during the various stages of its development, I am essentially going to break down China's growth into stages based on which form of State Capitalism it follows. I will first do a historical analysis of China's government and its involvement in China's economic growth beginning with the death of Mao Zedong. I will calculate the number of SOEs that were directly owned and operated by the government during the period after Mao's death and the number of companies where it was a majority shareholder. In creating this baseline based on historical analysis, I can draw direct

[21] Musacchio and Lazzarini, *Reinventing State Capitalism, Leviathan in Business, Brazil and Beyond*.8.

conclusions on the relationship between the form of government and economic model under Mao and how that affected which form of State Capitalism China developed. By dividing Chinese economic growth into a base form and then exploring its progression through the different models, it also then allows me to demonstrate a correlation between levels of economic growth and the nuanced forms of State Capitalism.

Measuring Economic Growth

The next question of my research seeks to address the main argument of my work of whether State Capitalism can create economic growth that can be sustained in the long term. My second hypothesis posits that the original form of State Capitalism in China could not create sustainable economic growth and only with the economic liberalization of the late 1980s and 1990s was China able to continue its growth in the long-term by transitioning to a different form. I argue that while the traditional form was able to sustain growth in the short-term, liberalization was required due to government corruption, mismanagement of SOEs, and lack of a profit incentive under the first model. Here, I define "sustainable economic growth" as a rate of growth which can be maintained without creating other significant economic problems in the future.

To test my second hypothesis, I will use a similar model to that of my first hypothesis, only substituting a quantitative analysis of China's economic growth from the death of Mao to the present. Essentially, I am going to align my economic analysis with the different models of State Capitalism that I find from my first analysis, but I will then divide each of these categories into two points of analysis: the change in growth throughout the model and the change in indicators of economic problems. In each case, I will take a baseline measurement at the point at I which I label "the start" of the model. Then throughout the period of each case, I will be calculating a percent change in both factors to determine 1) if there is a measurable growth that comes with model and 2) if that growth could be sustained under that model. For economic growth indicators, I will be measuring GDP growth, levels of foreign direct investment (FDI), and current account surpluses. For measuring the possibility of economic problems, what I label "problem indicators", I will be using data on wealth inequality, provincial growth inequality, and the balance between consumption and investment. In short, what I am looking for each model of State Capitalism to determine if the development is sustainable is that there is at least no significant decrease in the economic growth indicators and that there is no significant increase in the problem indicators. When transitioning to more liberal models, to prove a correlation between liberalization and sustainable growth, I expect to find that while there is at least no decrease in the growth indicators, there is a significant decrease in the problem indicators, signifying that the possibility of economic difficulties in the future is minimal.

Measuring the Ability to Reform

My final question seeks to address the fate of State Capitalism if it certain reforms are required in order for the model to be effective. I hypothesize is that if certain economic problems arise under the traditional model of State Capitalism, there needs to be a logical path to reform and move to the more liberal forms for it to be viable at all. Despite China's ability to transition to the more liberal forms of State Capitalism, I argue that another degree of liberalization is needed in order to maintain the same levels of growth that China has been able to achieve. Thus, the ability for a state capitalist country to create sustainable growth then is dependent on its ability to reform both economically and politically to follow the progression of models. To measure China's success in the long run, I will be divide my analysis into four sections: China's ability to balance consumption and investment and increase productivity, implement fiscal decentralization, and institute financial market and political reforms. In each case, essentially what I am going to do is test the transition from the traditional model to the majority investor model in China and see if it is legitimate enough to prompt further development in the long term.

I will first focus on how China has been able to rebalance its consumption and investment and increase factor productivity to create more balanced economic growth. To measure this, I will be using data from the Chinese Statistical Yearbook on consumption and investment in fixed assets as a percentage of GDP and using data from The Conference Board's Total Economy Database on China's Total Factor Productivity. I will establish a base level for each variable and do a percent change throughout the various models of State Capitalism to present. I do not specify an ideal balance between consumption and investment to use as a litmus test, but I expect to find that as China has progressed through the various state capitalist models, consumption as a percentage has risen while investment as a percentage has decreased. For factor productivity there should also be an increase, signifying that there is sufficient technological development to make further investment more efficient.

I then turn my attention to China's implementation of fiscal decentralization to test if the government can solve its regional growth and income gaps. Here, I define fiscal decentralization as the distribution of power and responsibilities from the national government to local governments in order to achieve economic efficiency and macroeconomic stability.[22] To empirically measure the success of fiscal decentralization, I will be using data from the Chinese Statistical Yearbook at the provincial level and following the ideas of Hehui et al. (2005) and Zhang and Zou (1998) that find that economic growth is positively correlated with effective fiscal decentralization. Taking data on provincial economic growth, I will be measuring the gaps

[22] Bilin Neyapti. "Equalization via Fiscal Decentralization" *Turkish Economic Association*, August 2005, 2.

that exist between urban and rural provinces as a result of China's growth model. Using data on income and consumption by province, I will do the same to measure the income gap. I will also be using provincial data on local government revenues and expenditures to determine the share of spending of local governments relative to the central government. Then in following the progression of models, I will calculate a percent change in these variables to determine how effectively the policy has been implemented and how subsequent economic growth has been distributed. While again I do not expect to find perfectly balanced growth and income by province, I should find that both of the gaps have decreased substantially and that the amount of spending from local governments relative to the central government has increased.

To measure financial market reforms, essentially what I will be doing is taking the baseline of the level of government involvement in Chinese economic growth from my first analysis and measuring the number of SOEs and the level of private capital accumulation. As a measurement for the prominence of SOEs, I will be using employment statistics from the Chinese Statistical Yearbook to measure how many people are employed by such enterprises. For private capital accumulation, I will be comparing consumption statistics from households versus the government as a percentage of GDP using the expenditure approach to GDP. Here, I should find that SOEs have gradually reduced their employment numbers, meaning that they are slowly becoming privatized, thus being allocated to the private sector consumption statistics. I should also find that household consumption has increased relative to government consumption as a percentage of GDP, signifying that there is higher private capital accumulation. This will show whether the Chinese government is allowing more market forces to enter the economy and will signify how sustainable Chinese growth is when faced with globalization. By measuring these changes, I can determine if there is a clear level of economic liberalization and if further liberalization is plausible.

Finally, I will address how the Chinese Communist Party has been able to reform politically using two primary factors: levels of democratization and levels of corruption within the government. In order to show a sufficient level of political reform, I should find that there is a substantial lowering of corruption, signifying that there is reduced conflict of interest between the government and the management of SOEs, as well as a rise in the Democracy Index, showing that the government is more responsive to the people instead of placating to its own interests. To quantify corruption, I will be using the Corruption Perceptions Index released by Transparency International yearly on 176 countries. This Index is based primarily on expert opinion from 13 public institutions and public opinion through a yearly survey. For democratization, I will be using the Democracy Index compiled by the Economist Intelligence Unit, an index that measures the state of democracy in 167 countries based on 5 factors: nature of electoral processes, functioning of government, political participation, democratic political culture and civil liberties. In short, by testing the levels of political and economic reform that China was able to achieve, I can test if there is a viable path of development from the traditional model of State Capitalism in the long-term.

Chapter 4

Theory of Measurements

In this chapter, I offer an analysis of the various economic indicators that I have chosen to use and explain why these indicators are crucial to China's economic development. I will first go into why I have chosen these variables and why they are important economic indicators of China's ability to transition to more liberal economic models. Then I will address criticisms of each variable and offer a rebuttal as to why I believe those criticisms to be unfounded.

Consumption, Investment, and Productivity Growth

The balance between consumption and investment in an economy is a key, consistent measure that is looked at to determine if an economy can achieve long-term growth as investment becomes less efficient. Consumption should be the overall goal of economic growth. As many others have noted using the Keynesian model of economic growth as a base, consumption is the primary driver of developed economies. While investment can serve as a main factor in the development of a country, it should only be used as a means to achieve consumption. Consumption is the only way to continue that growth in the long run due to the nature of the investment and aggregate production functions. Because the marginal product of capital is a decreasing function, as an economy develops the benefit from increased investment becomes less and less. This is where Total Factor Productivity (TFP) plays a key factor as it shows how efficiently an economy is using its resources. If a country posts high TFP numbers throughout its growth, then investment may be more useful as the benefit from each amount invested is rather high. But as Paul Krugman argued in his analysis of the Asian Tigers, a declining TFP signifies that there is a lack of technological innovation, which makes investment less useful.[23] Thus, either the gap that arises needs to be filled by consumption or there needs to be the corresponding technological development for investment to remain beneficial. While there is the benefit of globalization coming in the forms of FDI and international consumption, an economy cannot solely rely on other economies to step in when the domestic balance falls out of line. In some cases, internationalization can actually make the problem worse as FDI begins to crowd out domestic investment, causing investment to decline along with consumption. For development to be sustainable, there needs to be sufficient consumption and technological innovation to keep investment effective. Thus, it is necessary to measure these factors as a means of showing how well China can facilitate some increase in consumption as it aims to transition to the minority investor model because as it transitions, and markets become freer, the reliance on foreign consumption, the amount of domestic investment crowded out by FDI, and the inefficiency of investment because of lack of technological innovation will all become greater.

While consumption is widely accepted as the primary driver of long-term economic growth, there are some that argue that a country does not need to balance consumption and investment as drastically a I have laid out. As some have argued, consumption needs to be a primary part of the economy but does not necessarily need to be far and away the dominant part of the economy. Investment still needs to be high enough to facilitate that consumption and add technological innovation into the existing capital supply.[24] According to the St. Louis Fed, an economy that depends too much on consumption, such as the United States, is more likely to rely on foreign capital as domestic financing is not enough to keep up with these high levels of

[23] Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs*, November 1, 1994, https://www.foreignaffairs.com/articles/asia/1994-11-01/myth-asias-miracle.
[24] Mark Skousen, "Consumer Spending Drives the Economy? | Mark Skousen," September 22, 2010, https://fee.org/articles/consumer-spending-drives-the-economy/.

consumption.[25] Thus, these countries are more likely to post trade deficits, making them more reliable on foreign countries. However, simply because there is a debate over how much consumption or investment should be a part of an economy does not mean that we should not look to it as an indicator of economic growth. In addition, in order for investment to remain part of the conversation, a country must maintain productivity growth as well. In the way that I have presented this analysis, I am not looking for China to achieve a certain amount of consumption as a percentage of the Chinese economy, but rather looking for improvement in an already unbalanced category. I am also looking for there to be a sufficient level of TFP to keep China's large amount of investment efficient. Others have agreed-and my analysis will show-that during the first stages of development, China's balance of consumption an investment was grossly misaligned. Furthermore, its TFP was declining, signifying that investment was becoming less effective. Regardless of in the long run how China's consumption matches with its investment as a percentage of its economy, it needs to begin by starting to raise consumption relative to its investment. Thus, I am looking for them to rebalance their existing numbers, something that should be looked to as a long-term economic indicator.

Fiscal Decentralization

The process of fiscal decentralization, while controversial due to its varying results, has been looked to as a means of stabilizing growth and making governments more affective in managing growth. In addition to increasing economic efficiency and macroeconomic stability, decentralization also helps with income redistribution and improves technological

[25] "U.S. Consumers Can't Push Economic Growth Like Before | St. Louis Fed," accessed February 20, 2018, https://www.stlouisfed.org/publications/regional-economist/january-2012/dont-expect-consumer-spending-to-be-the-engine-of-economic-growth-it-once-was.

development.[26] There has been extensive research done on the effects of fiscal decentralization and a significant portion points to the need for countries experiencing this type of growth to institute such a policy. In their analysis of 46 developing and developed countries, Hamid Davoodi and Heng-fu Zou found that while fiscal decentralization had a negative effect on developing countries, there was a positive relationship between economic growth and fiscal decentralization in developed countries.[27] While some may argue that China is a developing country, I argue that it is far enough along in the growth process to reap the benefits from fiscal decentralization. In addition, Justin Yifu Lin and Zhiqiang Liu found in their analysis of China in 2000 that there was a positive relationship between fiscal decentralization and economic growth in China during the internationalization phase of China's growth.[28] This relationship primarily stemmed from more efficiency in China's institutional arrangements and more effective resource allocation. Finally, in their analysis of fiscal decentralization in China in the early 2000s, Jin, Qian, and Weingast found that this policy played a key factor in the development of the non-state sector. Because of changing fiscal incentives for local governments to increase competition in order to expand their revenue base, there has been a focus on the development of the non-state sector, which further helps Chinese development if the government is to withdraw from the economy long term.[29] Essentially what fiscal decentralization does is make the government more efficient in dealing with problems that are specific to different regions of the country. Because local governments are more responsive to economic and political issues in their jurisdiction compared to the central government, giving local governments better fiscal

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[26] Neyapti. "Equalization via Fiscal Decentralization"
[27] Hamid Davoodi and Heng-fu Zou. "Fiscal Decentralization and Economic Growth: A Cross-Country Study," *Journal of Urban Economics 43*, (1998): 255.
[28] Justin Yifu Lin and Zhiqiang Liu. "Fiscal Decentralization and Economic Growth in China," *Economic Development and Cultural Change*, (2000): 18.
[29] Hehui Jin, Yingyi Qian, and Barry R. Weingast, "Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style," *Journal of Public Economics* 89, no. 9 (September 1, 2005): 1721.

capabilities can help improve the nature of the state capitalist structure in China and increase the efficiency of public expenditures.[30] As far as measuring this reform, I have chosen to use tax revenues and expenditures as proxy because it measures how well local governments are operating. The idea behind this is that since the central government should be diverting more funds to local governments, local governments' revenues should be increasing. Since they need to be able to do more within their territories, their expenditures should be increasing as well, meaning that they are taking a more active position than in the past. So with the implementation of this policy, China's growth would stabilize and issues like the provincial growth and wealth gaps would be reduced, all making it more likely that China's growth continues in the long run.

While I am arguing that fiscal decentralization would create more stable and balanced growth, there have been differing opinions on the subject, specifically with whether it would create an economic slowdown if local governments did not cooperate with the central government. There have been analyses that have shown that growth slowed with this reform (see Zhang and Zou 1995). Essentially, the argument is that in developing countries, the efficiency gains from fiscal decentralization do not materialize because of the constraints placed on local governments by the central government. Because the central government is diverting more funds to local governments, the central government would have less resources to achieve its overall economic goals.[31] If more money is being funneled to rural areas or special economic development zones, then overall the government is less capable of dealing with macroeconomic issues. A second problem then arises as a result of the first. Because local governments are receiving more power and money, they do not necessarily cooperate with the central government. For example, there has been a common criticism of fiscal decentralization with

[30]Neyapti. "Equalization via Fiscal Decentralization"

[31] Tao Zhang et al. 1996. "Fiscal decentralization, public spending, and economic growth in China (English)." *World Bank no. WPS 1608*. Washington, DC.

regards to the steel industry. Because China is overproducing steel, the central government wants local governments to reign in their production. But this would lead to unemployment for steel workers, which local governments are not willing to accept. So they continue to produce which oversaturates the market. But even with these criticisms, fiscal decentralization has still been shown to be vital to growth because of the provincial growth and wealth gaps that exist in China. Because China is far enough along in the growth process, I do not consider it to be a developing country in the sense that Davoodi and Zou do. Furthermore, as Lin and Liu showed, China was already reaping the benefits of fiscal decentralization during the 1990s and early 2000s. Thus, due to the fact that China is now more developed than it was during their analysis, I argue that there is more of a benefit from this policy. The growth that China will be achieving will be more balanced across the whole country and the government will be better equipped to deal with this growth, making it more likely that China continues its development in the long run.

Financial Market Reforms

The role of a healthy private sector cannot be overstated in creating long-term, sustainable growth for an economy. Because of the general wastefulness of government apparatus due to bureaucracy and inefficient spending, a healthy private sector is needed to foster economic growth when the government begins to fail. As noted before, one of the various reasons that State Capitalism faces issues is with the misalignment of government initiatives with those of SOEs. While the government may have goals for employment or regional development, private firms main goal is profit. So when the government controls the primary enterprises in the economy, firms may sacrifice profit to cater to the government's goals. As the economy becomes more globalized and firms face more competition from foreign companies, they need to be able to focus on profit motives to be able to compete. While government subsidies have helped firms grow, this can only occur for so long before the negative effects of government inefficiency begin to outweigh the positives that come with subsidies. In addition, this private sector growth can be a key factor in alleviating poverty, which will also help with China's wealth gap. So, as China moves to the minority investor model, it needs a reduction in government presence in these firms so they can compete on a global scale, which is signified by a reduced level of employment by SOEs. As the government retreats from its dominant position in the economy, there needs to be the corresponding rise in private capital to allow the private sector to flourish, which I am using household consumption to measure. However, as we have seen in the various free market economies after the financial crisis in 2008, liberal economies need institutions to monitor markets. In order to avoid problems that arise from corruption and malpractice, the markets need domestic watchdogs and cannot solely rely on international organizations. So with a liberalization of financial markets, there needs to be a corresponding monitoring of those markets. Thus, an analysis of financial market reforms is crucial to any projection of China's growth as it will determine how China will develop when government inefficiencies begin to plague the economy and the private sector is needed.

There are two main criticisms of looking to financial market reforms as a means of measuring how a country can maintain its economic growth: that it can possibly make existing problems worse and that it assumes that free markets are inherently superior to government-led economies. In regard to the first point, critics point to the fact that a freer financial market does not necessarily translate to the distribution of wealth and employment across the private sector. While private sector development has the ability to help alleviate poverty, there is also a possibility that it sparks greater inequality if only the country's elite retain the wealth gained from private development. This is especially an issue in China, where part of the State Capitalist structure used in the earlier stages of development was network-based where political and business favors were exchanged for help with a firm's growth. In addition, by making it a requirement that financial markets be closer to the free market, it assumes that the free market is inherently better than a state-run economy. But the problem with these criticisms is that they fail to acknowledge that part of this reform is developing institutions to monitor the financial sector. Yes, an unmonitored private sector will have its own issues, but the key is creating institutions to allow for healthy private capital accumulation. Furthermore, there is a distinction to be made here between moving to a completely free market and moving to a more liberal market. I am not looking for China to immediately switch to a completely free market to further its growth, but rather I am looking for the government to lay a foundation that allows for the private sector to grow, thus preparing China to move to gradually move to the minority investor model. So as China transitions to a more liberal model and the economy becomes more globalized, the development of a healthy private sector-one that consists of higher private capital accumulation, a reduced role for the government, and more independent institutions-is crucial to continued development.

Political Reforms

The necessity for political reform has been a common critique of many state capitalist countries, but the reasons I offer differ in that I am focusing more on how this political reform will affect economic growth. As a proxy for measuring this, I have looked to the Democracy Index and Corruptions Perception Index because they offer an objective point of view into a country characterized by limited transparency. There are two main areas where I argue political reform will make a noticeable improvement for China's growth: its role in preparing the government for a larger, healthier private sector and its role in helping the government institute the prior reforms that I have mentioned. For the private sector, as mentioned above, government inefficiencies become a hindrance to growth as the economy becomes more globalized. In addition, corruption becomes an issue because of the network-style capitalism used during the first stages of development. In order for the private sector to reap the full benefits of liberalization, corruption needs to be limited so the elite class does not retain all of the wealth. Rigidity in government can ultimately lead to the downfall of an economy such as in Russia, where the inefficiencies of government led the economy too become too specialized and growth to slow down. Thus, as mentioned earlier, the government needs to reduce its position in the economy. But in addition to the better preparedness of the government, political reform will make the implementation of the other reforms easier. First, there is a positive relationship between government liberalization and economic equality. This would help with the immense wealth gaps that exist between urban and rural provinces. Furthermore, the liberalization of the government would give local governments more freedom as the central government reduces its control. This makes local governments more capable of dealing with regional issues and implementing fiscal decentralization. Finally, with a stronger private sector, this would increase domestic consumption, helping to rebalance it with investment.

The primary criticism against political reform is that it seems inherently counterintuitive to an economic model where a strong central government is crucial to success. By instituting political reform, the central government becomes undeniably weaker. With a model that depends on a strong government instituting control over the economy, that would seem to be a critical flaw that would cause the entire model to fail. Furthermore, a lot of people point to the network-style capitalism as the primary reason from the unmatched levels of economic growth. Thus, by doing away with the key connections that led to China's growth, it would cause the ultimate failure of China's model. However, I argue that political reform does not necessarily mean that the central government becomes ineffective. While the central government would become weaker, that is because more power is being given to local governments to empower them to deal with regional issues. I am also not looking for a complete transition to democracy for China, but rather a liberalization that minimizes the inefficiencies of the government. In addition, while the networks that developed during the first stages of development were an integral part of China's growth, they become a hindrance to growth as the prosperity of the private sector becomes more important. In order for financial market reforms to have any benefit, then the elite class cannot retain all of the wealth, something that would be certain to occur without doing away with corruption. If the private sector is to function efficiently at all-which it must if China wants to continue its long-term development-then limiting corruption should be a key goal as well. Therefore, political reforms are a must as it not only allows the government to be more effective in managing growth, but also helps with the implementation of the other various reforms.

Chapter 5

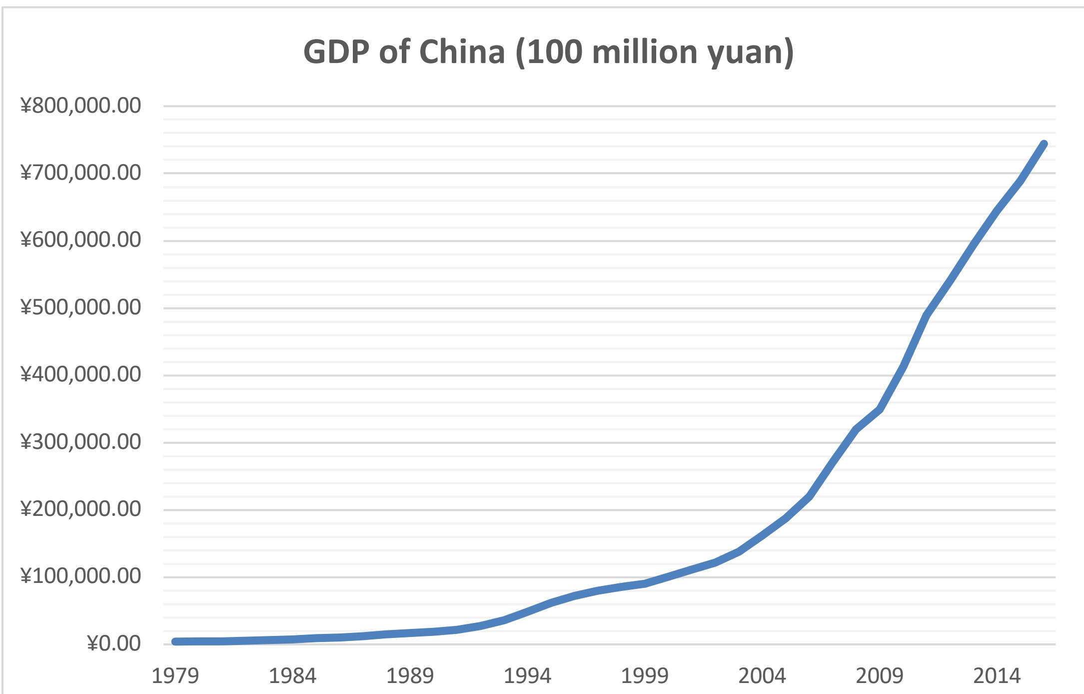
Analysis of China's Past Economic Growth

In this Chapter, I begin my case study of China with the examination of its past economic growth from the death of Mao in 1976. I divide China's growth into three phases: State-Led Development, Internationalization, and Global Influence. Each phase in addition coincides with a progression through the various models of State Capitalism, progressing from the traditional model to the majority investor model. In each case, I will begin by describing certain characteristics of each phase to offer an explanation for the way in which I have decided to divide China's past. Then, using data primarily from the Chinese Statistical Yearbook, I will analyze the subsequent economic growth achieved in each phase, noting how it has changed with the various models and identifying areas where reforms were needed. In doing this, I find that while China did have unmatched economic growth, certain issues arose that require reforms, namely the need to balance consumption and investment, balance provincial economic growth, fix inefficient financial markets, and implement political reforms. Using this analysis, I can set a definitive baseline of growth and do an analysis of China's ability to institute such reforms, leading to my eventual analysis of whether China can sustain this in the future.

Before going into my analysis, I must first address the data source I used, as it is from a rather unreliable source in the Chinese government. As many authors and news sources have noted, statistics on national accounts, employment, income and other factors coming out of China are altered to paint a favorable picture of the country and its economy.[32] However, despite the fact that the numbers are likely inflated, the data still serves as a reliable source for my

[32] Thomas Rawski. "What is happening to China's GDP statistics?," China Economic Review Vol. 12, no. 4, (2002): 347-354. Carsten Holz. "China's Statistical System in Transition: Challenges, Data Problems, and Institutional Innovations," The Review of Income and Wealth Vol. 50, no. 3, (2004): 381-409.

analysis given that I am aiming the prove that China's growth, and thus its economic model, are unsustainable. By using inflated statistics, my analysis should reveal a more optimistic outlook on the future of China's economy, showing that it has been able to create long-term growth and institute the various economic reforms that it needs. But if, using numbers meant to make China's economy look better, I can prove that China's growth is not actually sustainable, then my conclusion is actually reinforced as any further analysis using more objective numbers would only move the result more in favor of my argument.



Source: Chinese Statistical Yearbook, *China Marketing Resarch Co.,Ltd,* 2016.

State-Led Development: 1976-1990

Throughout the first phase of China's economic growth via state capitalist policies, heavy state intervention in the market combined with the private accumulation of capital created a traditional form of State Capitalism that led to unmatched economic growth, but suffered from the mismanagement of SOEs and the multifaceted nature of the state apparatus. Following the death of Mao in 1976, the Chinese government under Deng Xiaoping and Zhao Ziyang implemented a variety of economic reforms designed to allow for the private accumulation of capital while still maintaining heavy influence over the economy, beginning China's use of State Capitalism with an era of heavy state intervention. Such reforms included the corporatization of large enterprises while leaving small and medium-sized firms private as wells as the creation of special economic zones of carefully managed capitalism.[33] By taking control of these large enterprises, these companies were given preferential access to loans, land, and subsidies and the Chinese government was now involved in selecting the personnel on the boards.[34] In addition, by focusing on industries like oil, mining, gas, and banking, the government directed its economic growth into the sectors that it wanted to, deeming these sectors key to economic growth. What this did was strengthen existing business autonomies and give political cadres more political space.[35] Using these reforms, the Chinese government created a freer economy than what had existed under Mao, but still took steps to ensure that the Chinese government was the primary economic actor, using markets to accomplish its own objectives. This aligns with the traditional model of State Capitalism as outlined earlier in this thesis.

In this first phase of State Capitalism in China, we do see a significant increase in the overall economic growth of China as SOEs begin to take over the economy. Under the traditional model, we see a steady increase in the prominence of SOEs in the Chinese economy, increasing their employment by 34%. As China began its transition to the majority investor model, SOEs were employing over 9% of China's total population. This coincided with unprecedented levels

[33] Bremmer, *The End of the Free Market, 172*. Mcnally, *Sino-Capitalism,* 746.
[34] Bremmer, *The End of the Free Market,* 175.
[35] Mcnally, *Sino-Capitalism,* 752.

of economic growth. Beginning in 1979, GDP began to grow at an average of 15.5% per year with per capita GDP growing at 13.5% per year on average. This is primarily due to the high levels of TFP that China posted as well during this period. During this first stage, China's productivity tripled, signifying that there was significant technological development. While there was an imbalance between consumption and investment, investment was more beneficial here because of these high levels of productivity growth. China's growth is astronomical when compared to the United States at the time, which was averaging between a 3 and 4% growth rate and was only able to achieve above a 7% growth rate one time between 1979 and 1990.[36] China also began to run some significant current account deficits and FDI began to increase by 38% per year on average, signifying that China was viewed as credit-worthy by foreign investors. So with the implementation of economic reforms and the use of the traditional model of State Capitalism, we see SOEs significantly influencing the economy, leading China to achieve unmatched economic development while gaining confidence in the eyes of foreign investors.

But despite the new levels of economic growth achieved during this time of heavy state intervention, this phase is also consistent with the various problems with the traditional model outlined by Bremmer and Mussachio and Lazzarini. It is during this phase that we see some of the various problems start to arise within that growth, namely the imbalance in provincial wealth and economic growth. Due to the fact that the largest businesses in China now had significant ties to the government, often with government personnel becoming key members of these businesses, these large enterprises now suffered from complex nature of a state-run economy, as is common across the board with state capitalist countries using the traditional model. Because the government is now using the economy to accomplish its own objectives, its objectives may not necessarily align with those of a company whose primary concern is earning a profit. When

[36] World Development Indicators, The World Bank.

the government's goal is to focus growth on its special economic zones, it may mean sacrificing the goals of the company. So what we see is the artificial development of certain areas of the country, leading to imbalanced growth.

Despite significant GDP growth as an overall country, the economic growth was confined to the provinces where the government created its special economic development zones. Provinces like Shaanxi, Guangdong, and Xinjiang saw their growth skyrocket at an average of between 2 and 3 percent higher than the provinces of Qinghai, Ningxia, and Hainan that remained bogged down. This then led to a significant imbalance in urban and rural wealth. During this time, urban per capita income was rising at 2% higher than rural per capita income, worsening the already wide gap that had existed under Mao. By 1990, rural per capita income was under half of urban per capita income. In addition, in this first phase we begin to see the gap developing between consumption and investment widening. While this is a small gap compared to the one that developed as China began to open its doors to globalization, we see that the problem began with the traditional model and the reforms instituted under Deng Xiaoping and Zhao Ziyang. Between 1979 and 1990, investment as a percentage of GDP increased on average 5% more than consumption. By 1990, while investment was making up almost a quarter of China's GDP, overall consumption was making up less than one ten millionth of 1 percent of overall GDP. So what we see is that despite the increased economic development of China with the traditional model, we also see the underpinnings of more significant issues that would need to be addressed by future progression to the other state capitalist models.

Internationalization: 1990-2008

As a result of China adopting more free-market policies and opening its doors to more foreign capital, it was able to further facilitate its growth, but it still suffered from imbalances in consumption and investment as well as in provincial growth. As China began to become a larger global player economically, due to the globalized nature of the existing system, China was forced to adopt more free-market principles and join the international structure in order to sustain its levels of growth.[37] Thus, we see China joining the World Trade Organization in 2001. Because it had been rather closed off to the economic system during the first phase of development, China had one of the highest absorption capacities for the forces of globalization.[38] Between 1990 and 2008, under the leadership of Jiang Zemin and Hu Jintao, China began its well-known policy of export-led growth combined with its rapid development and use of Hong Kong's financial markets and its continued subsidizing of strategic industries. China began to open to more FDI, specifically in the manufacturing and retail sectors and took steps to make a more flexible labor market.[39] In addition, during this second stage of development is where we see the use of China's other well-known policy of keeping an artificially undervalued currency in order to facilitate cheaper exports, which played a large role in the huge spike in growth that we see during this period. But while opening up to more foreign investment and adopting more free market policies, China remained under the traditional model due to the fact that it still was the primary driver of the economy, exerting direct control over China's major industries and enterprises. This led to continued issues as noted earlier regarding the mismanagement of SOEs, but also furthered existing problems like the imbalance between consumption and investment and the differences in provincial wealth and economic growth.

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[37] Mcnally, *Sino-Capitalism,* 755.
[38] Ibid.
[39] Mcnally, *Sino-Capitalism,* 756.

Throughout the internationalization stage of China's growth, there is a large spike in economic development, coupled with an increase in China's overall wealth and an increase in the influx of foreign capital. Between 1990 and 2008, the Chinese economy grew at an average rate of 16.7% overall and 15.5% per capita, which is a 1.2% increase in overall GDP growth and a 2% increase in per capita GDP growth. That is also an average growth rate more than three times the highest growth rate that the United States was able to achieve during the same period (4.7%).[40] We also see China running significant current account surpluses in eighteen out of the nineteen years in this stage as a result of its export-led growth model, increasing its surplus by 218% between 2005 and 2008 alone. In addition, despite the fact that China only opened its doors to significant FDI in manufacturing and retail, FDI began to skyrocket as well, signifying the continued trust by foreign investors in the Chinese growth model. With an average increase of 29.6% during this period, FDI in China in 2008 was 49 times the level it was in 1990. So overall under the continued use of the traditional model, combined with an export-led growth model, the implementation of more free market policies, and easier access to Chinese markets by foreign capital led to continued increase in economic growth and in foreign investor confidence, while increasing China's overall wealth as well.

However, even with the huge spike in growth during this internationalization phase of China's growth, we also see that China's export-led growth model and its opening up to FDI created new underlying problems with its development and made existing problems worse. From 1990 to 2008, China still suffered from the same issues of the traditional model, namely the misalignment of objectives between the state and the leaders of SOEs and the complex nature of the state development apparatus. So problems that existed during the State-Led Development phase continued and were made worse during this stage. As mentioned earlier, China's quick

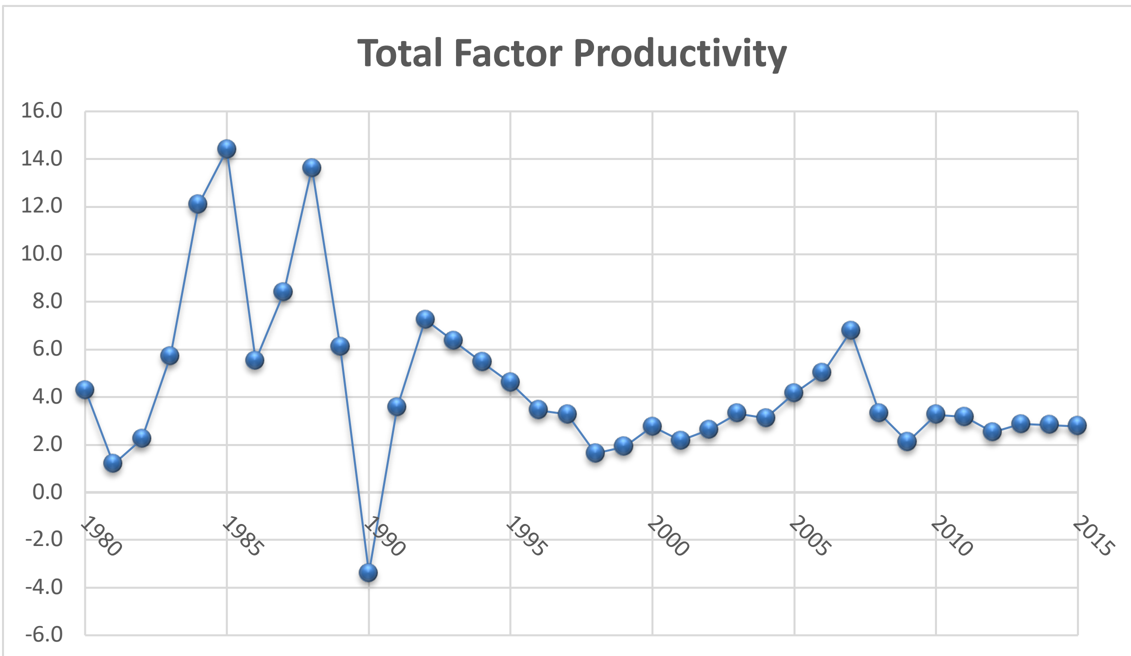
[40] World Development Indicators, The World Bank

development left an imbalance between consumption and investment and created gaps in growth and wealth between various provinces. Here, we see both of these problems getting worse. With regards to the growth gap between urban and rural provinces, we see that the growth for urban provinces jumped to 16.8% while rural provinces remained 3 to 4% lower. But, keeping in mind that this percent change occurred based on numbers that were already far apart after the first stage of development, this meant that by the end of this stage, rural GDP was 8% of urban GDP. This led to an increased wealth gap between urban and rural areas, where urban per capita income continued to rise at a 2.5% faster rate than rural wealth. By 2008, urban workers had accumulated four times more wealth than their rural counterparts.

Furthermore, we see here that the balance between consumption and investment got worse as well as the government took steps to favor investment over consumption. During the internationalization phase, in order to facilitate its export-led growth model, the Chinese government actually suppressed consumption and encourage investment by offering high savings and investment rates.[41] So a problem that was already bad was made even worse as investment rose to a 21.7% growth rate while consumption fell to a 13% rate. Again, because the rates were calculated using numbers that were already far apart from the first stage of development, in 2008 the imbalance was so bad that investment was making up 54.1% of China's overall GDP while consumption remained under a 100 millionth of GDP. But with this balance getting progressively worse, there is also a significant decrease in total factor productivity (TFP) during this period. There is an argument to be made that during the first stage, investment should be favored over consumption due to China's high TFP from 1979-1990. However, as the figure shows, China's TFP at the end of this stage was less than a quarter of what it was at the height of the first stage, even turning negative at one point. This means that each factor input was producing less national

[41] Mcnally, *Sino-Capitalism,* 759.

income, showing that China's growth was based on inputs by hiring more workers and spending more money. So overall the existing problems were getting worse as the government continued to focus growth on its special economic zones that were involved with the key industries the government wanted to focus on, even when it was not the most efficient use of resources.



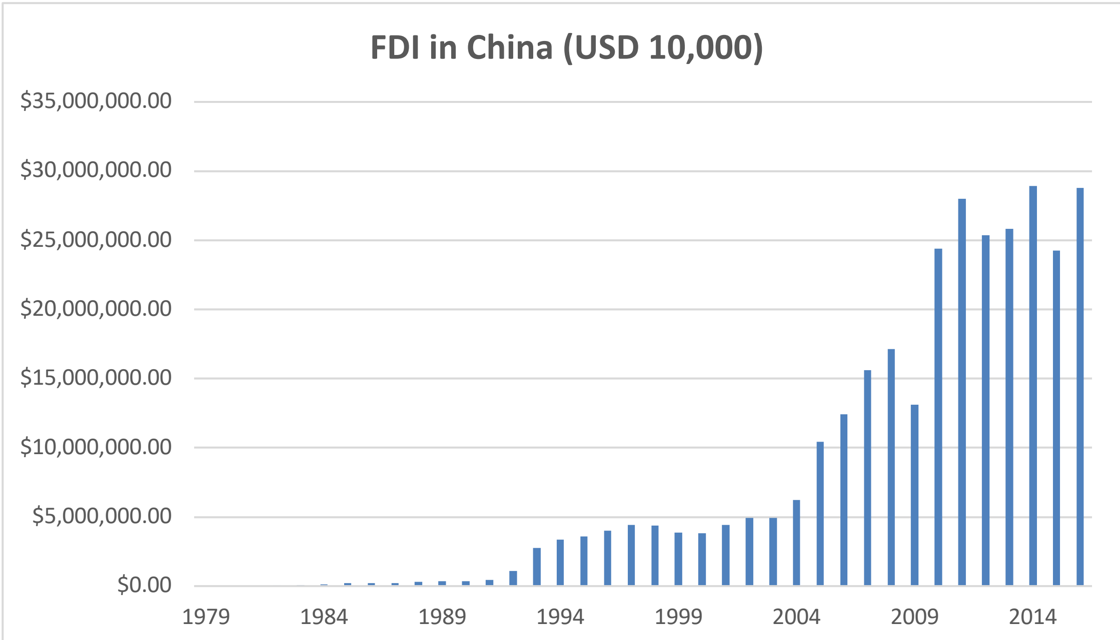
Source: China Development Indicators, *The World Bank Group,* 2018.

But in addition to the worsening of the existing problems created under the traditional model, this second phase also saw the emergence of a new problem indicator in the way that the government was propping up the country's economic growth and crowding out the private sector. During this second phase, we begin to see a steady decline in household consumption as a percentage of GDP coinciding with a steady increase in government consumption as a percentage of GDP along with the continued increase in the percentage of the population employed by SOEs. As noted prior in this chapter, SOEs were already employing around 9% of the Chinese population at the start of this developmental stage. In this stage, the number of people employed by SOEs continued to rise by 15% and government consumption as a percentage of GDP rose to almost 17% of China's total GDP. This coincided with an overall decrease in household consumption of almost 14% at the same time. So, what this means is that during this phase the Chinese government is taking an increasing role in economic growth while crowding out private capital accumulation. As SOEs, which were the largest firms in China to begin with, grow even faster and begin to become the main economic drivers, they reduce the purchasing power of the private sector and of the rest of the Chinese population. This not only creates issues with the private sector in trying to maintain its position in economic growth, it also brings up the issue of national welfare and contributes to the issue of the wealth gap. This overpowering of the economy by SOEs causes the economy to become dependent on the government and its actions, which will cause further problems in the long run as a sufficient level of private capital accumulation is necessary when transitioning to the more liberal models of State Capitalism.

Global Influence: 2008-Present

With the free market going through one of its worst financial crises in history, the final stage of China's growth is characterized by its increased presence in the international system and its transition to the majority investor model of State Capitalism. As China entered the last stage in its growth model with unparalleled economic growth, the free market suffered from a serious financial crisis, made worse by the globalized nature of the international economic structure. Because the free market was suffering and China was prospering, China seized the opportunity to turn its economic power into regional hegemony, aiming to move to a more powerful place in the international system. Thus, in this last stage, the Chinese government took steps embracing internationalization instead of rejecting it. We see China relying more on institutional frameworks like the WTO and moving to make the yuan a more widely used currency with the hopes of elevating it to reserve currency status. In this last stage, while continuing its use of capital controls to monitor flows in and out of the country, China also used global finance to create and absorb offshore pools of yuan and began to enter into currency swap agreements with countries like Argentina, Russia, and South Korea.[42] There is also a trend here where the Chinese government was slowing allowing its currency to appreciate in order to be more usable globally.[43] In addition, with all of the extra wealth gained from the first two stages of development, China also moved to become a more powerful player in the international system by directing that wealth into investment in strategic areas of the world, with a sizeable increase in investment in the United States, South America, and Africa. By investing in these strategic regions using its excess wealth, China was not only becoming an even larger net creditor to the other most powerful nations in the world, but was also becoming a key factor in global development. With internationalization taking over the Chinese economy, the Chinese government also began to transition to the majority investor model. Even though the government remained a large driver of economic growth by offering easier access to subsidies and lower interest rates for SOEs, there is also a retreat from its dominant position in the economy, letting more SOEs operate as private enterprises while the government took more of investor role. Because the government still held majority shares in many of these SOEs, there is still the effect of government operating in these businesses, but it is diminished.

[42] Mcnally, *Sino-Capitalism,* 761.
[43] Bremmer, *The End of the Free Market, 178.*



Source: Chinese Statistical Yearbook, *China Marketing Resarch Co.,Ltd,* 2016.

During this final phase of China's development, as we see China start to take a bigger role in the international system and reduce government economic presence, China's growth, while slowing slightly due to the limits of State Capitalism, remains stimulated by the increasing globalized nature of the economy. In this stage, China made significant ground on the problem caused by the prominence of SOEs in the economy. The Global Influence phase of China's growth saw employment drop by 41% compared to the height of the internationalization phase. This is presumably as result of the fact that companies that were previously dominated by the state were now transitioning to private entities. From the start of the financial crisis to the present, GDP growth slowed to an average of 12% while per capita GDP slowed to an average of 11.4%. While this is still significantly better than the United States during this period (which was posting no higher than 2.5% growth and had negative growth as well), this is a decline from the other two stages. This is where the limits of State Capitalism start to come into play. Due to issues raised earlier, like the complex nature of the state structure and the mismanagement of SOEs, we see this decline. However, with the increasing globalized nature of the Chinese economy, China's growth does not slow as significantly as it would have had it continued to be closed off. China still ran significant current account surpluses, propped up by the western economies in financial crisis, who borrowed in order to save their economies. There is also an average increase in FDI of 10.4% during this period. So even with the economic "slowdown", China still posted extremely good growth numbers, combined with a continued increase in wealth and a fostering of FDI as it took advantage of the international economic order during its transition to the majority investor model.

While the prominence of SOEs has decreased in this final stage and made more room for the private sector, we still see the imbalance between consumption and investment and the provincial growth and wealth gaps getting worse. With regards to the growth and wealth gaps, this stage saw the worst imbalance of all growth stages. While rural income grew at a rate 2.5% higher than urban income, these rates were calculated based off numbers that were again already far apart. By 2016, the wealth gap was the largest it had been since the start of this analysis, with urban per capita income standing at 2.7 times rural per capita income. With the provincial growth gap, there is a similar story. The developed provinces of Guangdong and Shandong saw their growth explode while the underdeveloped provinces of Ningxia and Qinghai continued to be bogged down. However, in this phase, there is also the emergence of a third tier of provinces, experiencing growth between the highest and lowest performing provinces. For example, the provinces of Sichuan, Tianjin, and Hebei grew rapidly during this period, putting them above the growth of the provinces of Ningxia and Qinghai. But due to their starting point being far behind

Guangdong and Shandong, they still remained behind the higher growth numbers. Presumably this comes a result of some rural provinces continuing to grow while extremely rural provinces were left out of this growth as well. In both cases, we see this significant imbalance made worse due to the effects of globalization. Because only developed areas are able to compete in the international market and withstand the forces of globalization, these areas continue to do better while the underdeveloped areas fall victim to more efficient markets. With the inability to compete internationally, combined with a lack of help from the Chinese government, rural provinces continue to slow and real rural income shrinks. So with China's move to the majority investor model, combined with the introduction of international market forces, the provincial wealth and growth gaps were brought to their worst levels of any developmental stage.

In addition, the balance between investment and consumption was made worse by the last stage of development. Again, we see the widest gap during this last stage as internationalization just serves as a catalyst for China to continue down the same developmental path, failing to address the problem indicators that had been emerging throughout its growth. This coincides with a continuing decline in TFP of 17.8%, meaning that the inefficiency of investment has carried over from the last stage. However, there is a new factor that begins to emerge as well here with regards to consumption. As China has begun to embrace internationalization, its economy has seen a spike in foreign consumption, particularly from the United States. With exports to the US rising by 37% from 2008, China is now the US's largest importer. But during this phase, Chinese consumption as a percentage of GDP fell by 9%, while investment continued to rise over 251% between 2008 and 2016. So we are seeing that the overall balance between consumption and investment has gotten closer, but that the gap between domestic consumption and investment has gotten worse. What this does is add to the existing problem by making China too dependent on foreign consumption. Should the trend of domestic consumption falling continue, then it would cause China to become stuck in its export-led growth model, where it has to sustain the same levels of exports in order to facilitate foreign consumption to prop up its growth.

China Has its Work Cut Out

Throughout the various stages of China's development, despite unmatched economic growth and the accumulation of wealth, certain problem indicators point to the need for reform if China wants to see this growth continue. First, the gross imbalance between domestic consumption and investment must be addressed to create growth that is less dependent of foreign economies and more focused on increasing productivity growth, where each yuan invested creates more national income. The gap in both economic growth and wealth between urban and rural China must be addressed as well to avoid a poverty crisis that could create future problems for the government and prevent it from instituting the next phase of its growth model. In addition, the government needs to reduce the prominence of SOEs, signifying the privatization of major industries and the ending of the problems with the complex state apparatus and the mismanagement of State Capitalism. Finally, I add that government reform is also necessary in order to achieve the above reforms, but also in order to have the ability to institute the next stage of State Capitalism, the minority investor model. In short, China must rebalance domestic consumption and investment and the provincial wealth and growth gaps, reduce the prominence of SOEs in the economy, and institute government reform to continue its growth. Thus, China has its work cut out for it and these next years are crucial for the continuity of its economic rise. In the next chapter, based on

China's past growth and given the problems that its needs to address for it to sustain its growth, I predict whether China has the ability to institute such reforms.

Chapter 6

Assessment of Chinese Reforms

In this chapter, I analyze how China has been able to institute necessary reforms and make a prediction on how its effectiveness in doing so will affect its long-term growth. I divide this chapter into four sections based on the problems that I have deemed critical for China to continue its development: rebalancing consumption and investment and increasing productivity, instituting fiscal decentralization, financial market reform, and political reform. Here, I argue that while China has started to implement financial market and political reforms, it has insufficiently addressed concerns over the provincial wealth and growth gaps. In addition, with the balance between consumption and investment, while the balanced has improved, I argue that the Chinese economy is too dependent on foreign economies and must continue to facilitate domestic consumption. Essentially, with the progression that I have laid out for China's growth model, the next form of State Capitalism that China must transition to is the minority investor model. With my analysis I aim to find out if that is possible. For each section, I first begin with an analysis of why implementing each reform is necessary in order to achieve sustainable growth. Then, using a combination of the analysis from my last chapter as well as data on current plans from the Chinese government to foster growth, I make a forecast on the likelihood China can sufficiently realize each reform in the future. I finish with a prediction of the effect on China's overall growth and what needs to be changed for its growth model to be viable.

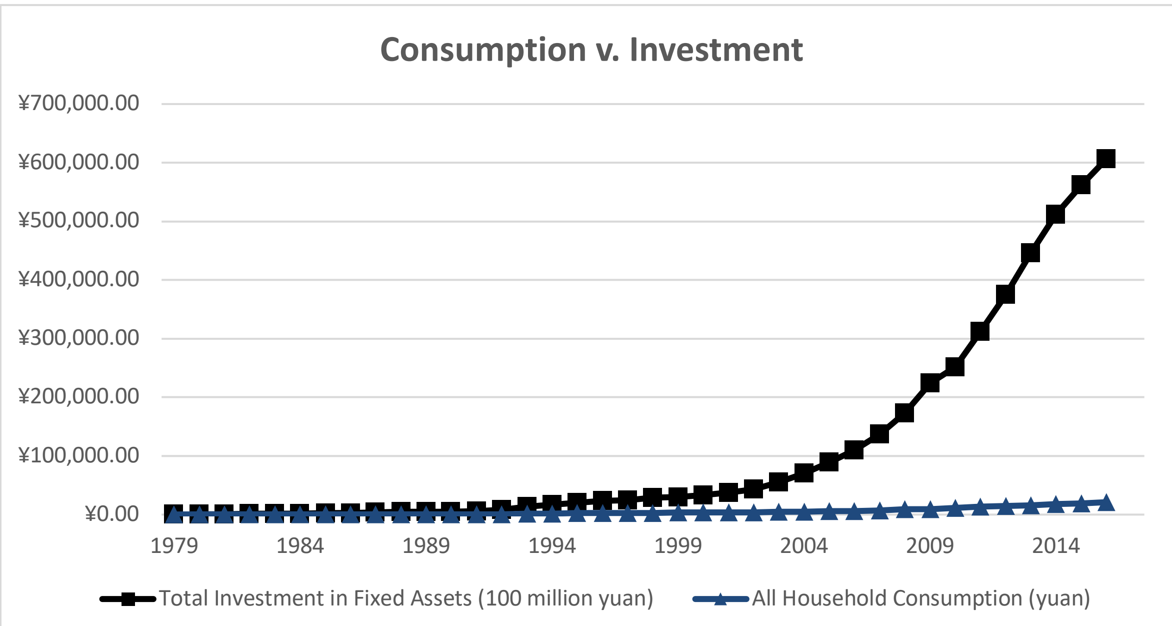
Consumption, Investment, and Productivity Growth

The first problem I argue should be addressed is the balance between consumption and investment and the issue of declining productivity. Based on my analysis in the last chapter, I showed that throughout the various stages of development, the gap between domestic consumption and investment as a percentage of GDP continued to worsen until they were the widest they had been during the last stage. Furthermore, along with this overinvestment, we saw in the last chapter TFP was also declining, meaning that each yuan invested was not going as far. So a large part of China's growth during the internationalization and global influence stages was based on spending more money and hiring more workers. In addition, with the increase in globalization that came with the majority investor model, while consumption overall improved, it was being propped up by the United States, making China too dependent on foreign economies. Thus, as China approaches a transition to the minority investor model, this problem will only get worse unless the government takes action to normalize this relationship. In this analysis, because of the wide gap that already exists and because of the fact that it is a complex process to fix such an imbalance, I looked for simply indicators that this problem could be addressed if China wants to continue its development, specifically if there would be a reduction in investment and a facilitation of domestic consumption. However, even with these indicators, I found that the prospects of implementing this reform looks bleak. Even though the Chinese government has shown signs of addressing this problem, I argue the balance between domestic consumption and investment and TFP show no signs of improvement. While foreign consumption continues to rise and make the overall balance better, China's growth will only become more dependent on foreign economies unless further action is taken to foster domestic consumption and increase productivity.

While the Chinese government has taken steps to improve consumption and draw back investment, it is still too reliable on investment and foreign economies. In addition, there has not been the necessary technological development and innovation to maintain sufficient productivity and facilitate further investment. In the past decade, under President Xi, the Chinese government has announced a transition towards a consumer-led economy with its thirteenth five-year plan, focusing on the equalization of basic public services and the increase in public benefits programs.[44] In addition, the government has placed more emphasis on urbanization, channeling more money into cities to not only prepare for the continued influx of people from rural areas, but also to allow children to spend more time in school. All these instituted reforms have the goal of curbing investment and raising consumption by increasing the marginal propensity to consume. First, urbanites have a better ability to spend than do their rural counterparts. By increasing social programs like social security coverage, people are less inclined to save their money and more likely to add to the economy. Furthermore, if children are able to spend more time in school, it will encourage parents to have more children, thereby adding to consumption. While having more children encourages saving, it also facilitates consumption as parents spend more on a greater number of children. Furthermore, China has started to implement more research and development programs aimed at increasing its factor productivity. As more foreign investment flows into China, the government has also placed a focus on making that investment more efficient through technological development. In an attempt to increase technological innovation, it has introduced incentives for people to file patents including offering residence permits, cash bonuses, and lucrative government contracts.[45] Because of these incentives, patent applications have skyrocketed in China to the point that it is the global leader in patent

[44] "China's Great Balancing Act: The Shift from Investment to Consumption," *The Telegraph*, March 15, 2017, http://www.telegraph.co.uk/news/world/china-watch/business/consumption-driven-growth-in-china/.
[45] "Patents, Yes; Ideas, Maybe," *The Economist*, October 14, 2010, https://www.economist.com/node/17257940.

applications with an 18.7% increase applications in 2016 alone.[46] Because of these programs, we do see consumption adding more to the GDP in China. According to the Chinese National Bureau of Statistics, consumption accounted for over 60% of the added GDP growth in the first nine months of 2017.[47] In addition, investment has been slowly curbing, its growth slowing 13% under President Xi.



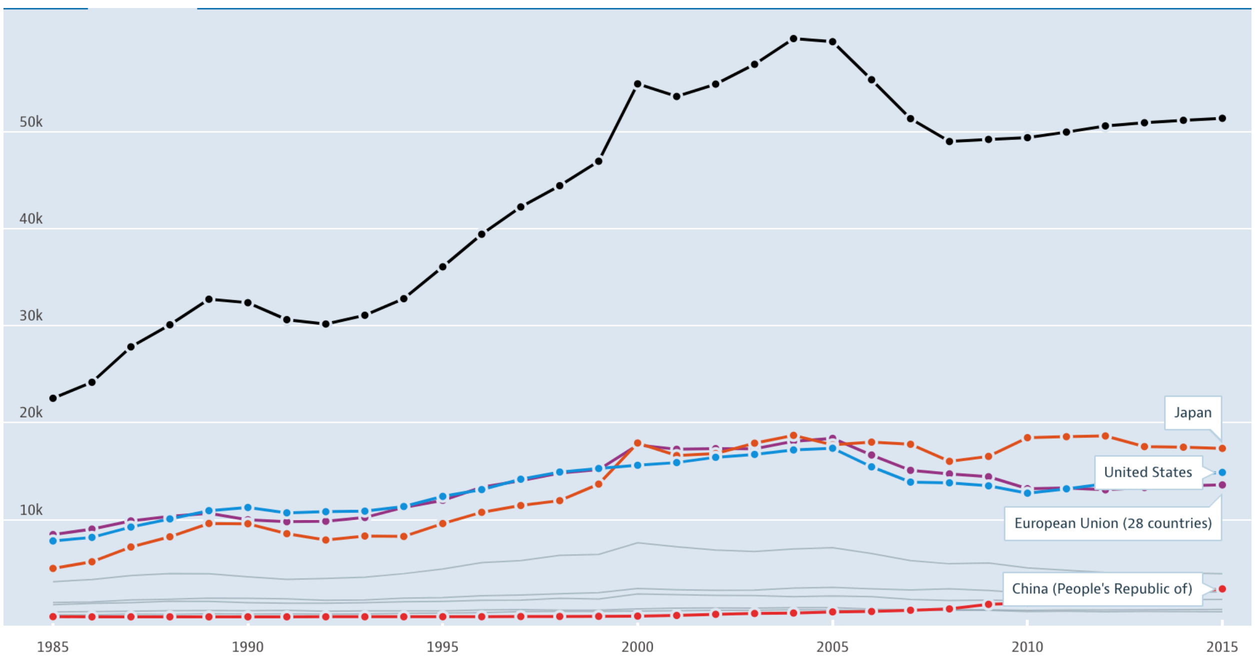
Source: Chinese Statistical Yearbook, *China Marketing Resarch Co.,Ltd,* 2016.

However, the new consumer-based economy that China has been touting is not as great as seems, characterized more by saturation of investment, crowding out by FDI, and reliance on foreign consumption. First, as mentioned in the last chapter, as the Chinese economy has become more globalized and open to foreign capital, domestic investment has been crowded out by the

[46] World Intellectual Property Indicators 2016, Economics & Statistics Series.
[47] "China's New Consumption-Driven Economy Isn't What It Seems," Nikkei Asian Review, accessed January 30, 2018, https://asia.nikkei.com/Politics-Economy/Economy/China-s-new-consumption-driven-economy-isn-t-what-it-seems.

influx of foreign investment. In the past decade, while there has been a steady decline of investment, there has been a simultaneous increase of 10% on average per year in FDI. So the decline in domestic investment can be partially attributed to the rise in FDI taking the place of that capital. Even so, investment is still hovering above 40% of China's GDP, compared to other developed countries where investment stays around 20%.[48]

Triadic Patent Families Total Number Total, Number, 1985 – 2015



Source: Patents by main technology and by International Patent Classification (IPC), *OECD Data*, 2018

Furthermore, while the balance between consumption has been altered, it has been because of a decline in investment more than it has been because of an increase in consumption. As is predicted by the aggregate production function, because TFP has remained low, the benefit coming from investment begins to slow as a country develops and investment becomes less

[48] Ibid.

useful. Had China made significant progress in innovation to increase its productivity, then the imbalance of consumption and investment would be offset by the high degree of factor productivity. But even though there has been an explosion of patent applications in China due to government incentives, breaking down these applications by sector shows that China is still lagging far behind other developed economies. While 71.7% of patents were filed in information and communications technology, China still only made up 5.2% of world patent applications in this sector. The United States accounted for 27% of world applications in this sector. China was also far behind the US in triadic patent applications as well, with the US filing 41% of world applications and China filing 1.48%.[49] In addition, the quality of all of these patents has been a topic of great scrutiny due to the incentives offered by the government. China has been more focused on quantity over quality and has therefore offered incentives both for the applicants and for the patent offices. Because patent officers receive benefits for granting more patents, the quality and originality of new patents is a point of skepticism in determining actual innovation in China.[50] Even so, this has had little effect on indicators of factor productivity and innovation. Despite the goal of improving technology and R&D, China's TFP is still the lowest it has been in the 21st century, making the possibility of reform seem extremely unlikely.

Finally, the problem of reliance on foreign economies continues to exist as well. In 2017, China was once again the largest exporter to the US. But even with the increase in domestic consumption in China, it was an increase starting from an already poor level. But because China is now dependent on foreign consumption, another risk that arises is foreign sentiments toward China. With some Western economies toying with the idea of electing more conservative governments, trade deficits with China are becoming less popular. For example, in the US China

[49] "Are Patents Indicative of Chinese Innovation?," *ChinaPower Project* (blog), February 15, 2016, https://chinapower.csis.org/patents/.
[50] "Are Patents Indicative of Chinese Innovation?"

has become a scapegoat for US economic problems, prompting companies to turn domestically or to other developing countries. While China remains the largest exporter to the US, it is an added risk that the fate of overall consumption in the Chinese economy hangs on the sentiments of foreign consumers.

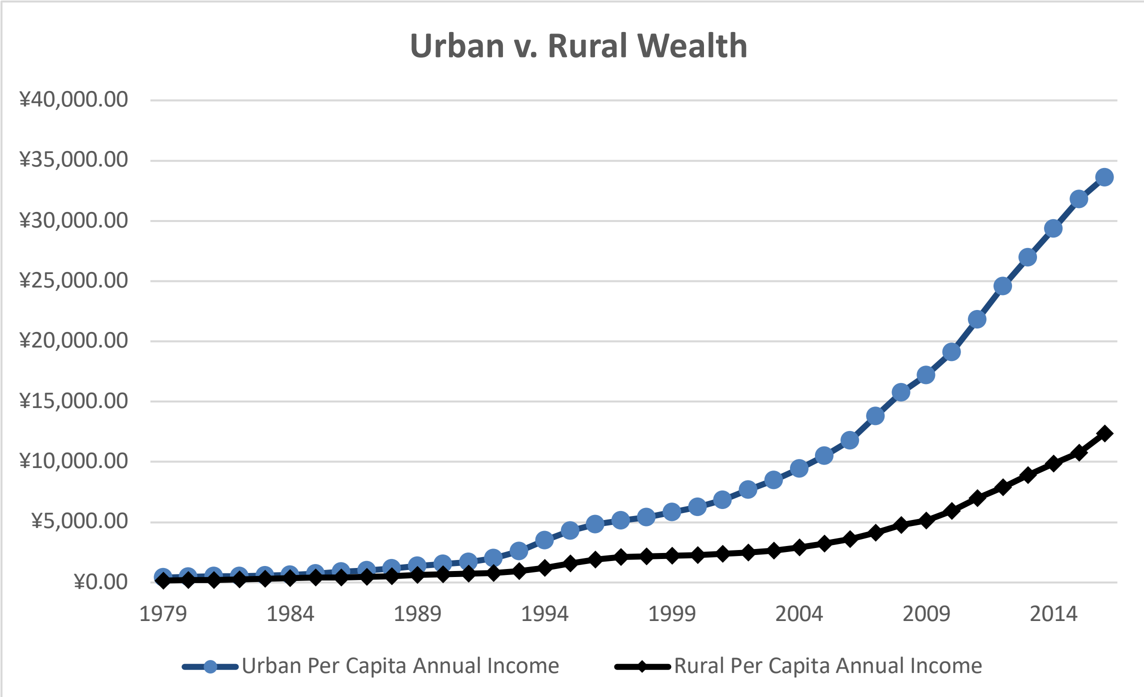
As far as the likelihood that China has the ability to implement these changes, I argue that the chances are not very high. Due to China's framework of an export-led growth model combined with high levels of investment, it is hard to artificially draw back investment and boost domestic consumption. Adding the fact that China has shown no signs of improving its factor productivity, it is highly unlikely that we see this reform implemented in time for China to transition to the minority investor model. Therefore, even with the improvement of the consumption and investment imbalance, China still needs to take more action in this area to deal with the saturation of investment, crowding out by FDI, and reliance on foreign economies or else its growth will begin to bog down if it wants to transition to a more liberal economy.

Instituting Fiscal Decentralization

The next reform critical to the continued development of China's economy is implementing fiscal decentralization in order to combat the provincial economic growth and wealth gaps. Fiscal Decentralization can be described as increasing the effectiveness and flexibility of government by delegating or deconcentrating previously centralized fiscal authority to regional and local governments.[51] Essentially, decisions on the nature of public expenditures and the use of revenues is shifted toward subnational governments, who can more efficiently allocate resources. As we have seen from my original analysis, significant growth gaps between provinces developed as the Chinese government created special economic zones in which to

[51] Fiscal decentralization, 1.

focus its development, causing certain provinces' growth to skyrocket while others were left stagnating. Furthermore, this caused a significant wealth gap to develop as well, where urban workers income was exponentially higher than their rural counterparts. In this case, because instituting fiscal decentralization is a complex process that takes decades to implement, I am searching for specifically the realignment of incentives between the central government and local governments, namely through the improvement of channeling revenues to local governments. While the Chinese fiscal system is somewhat decentralized, the combination of political centralization and the existing gaps makes this an issue that needs to be addressed. Nonetheless, even though the Chinese government has begun a process of decentralizing its fiscal structure and transferring more power to local governments, I argue that it has been insufficient for dealing with this issue and more needs to be done in order to solve the misalignment in the Chinese fiscal structure.



Source: Chinese Statistical Yearbook, *China Marketing Resarch Co.,Ltd,* 2016.

While we have seen a slight improvement in revenues and expenditures in rural provinces relative to urban areas as well as a slight increase in the relative spending of rural governments compared to central government spending, there is no clear evidence that China has instituted an effective form of fiscal decentralization, indicated by the disparity of increases between provinces and the continued wealth gaps. Under President Xi, while there has been no explicit initiative to institute such a reform, there has been an increase in the channeling of funds toward local governments. This has taken the form of a revised tax structure to give more funds to local governments and a reduction in the spending demands from the central government to local governments. Another mechanism includes the fiscal incentives of local governments to promote local business development, which further rewards local governments by increasing the local tax revenue base.[52] Despite this not being a formal policy of fiscal decentralization, there have been positive effects from this policy that would be similar to those of such a formal policy. There has 35% higher increase in revenues to rural governments compared to urban provinces and a 25% higher increase in expenditures. In addition, the relative shares of spending between central and local governments has increased to favor local governments. Between 2008 and 2017, the rural share of spending compared with the central government of China had increased by 4.3%, while the urban share of spending increased by 2.6%. These policies have also played a key role in the non-state sector, where local governments have seen their marginal revenues increase by 10% since President Xi came into power.[53] So what we are seeing is that even though China has not formally declared this policy of fiscal decentralization, we are seeing similar effects that would come with such a policy due to the fact that more money is flowing to local governments who have more freedom to use those funds as they deem necessary. While this may slow overall growth, it has given local governments the ability to deal with more regional problems, namely unemployment and slowing growth for the more rural provinces. This leads to more balanced growth which, while slightly slower than the numbers China has been posting, will make it more likely that China extends its growth long-term.

However, despite the limited success that has come from this policy, there is a doubt over if this policy can continue and if China can solve the existing growth and wealth gaps without a formal policy. Even though we see that the shares of spending from local governments relative to the central government has increased, a 4% increase over eight years really is not as effective a change as it may seem. When taking into account both inflation and the fact that China's economy as a whole was growing at an average rate of 12% over the same period, the

[52] Jin, Qian, and Weingast, 1721.
[53] Jin, Qian, and Weingast, 1738.

achievements seem less than ideal for an economy that was already experiencing imbalanced growth. This is also indicated in the immense wealth and growth gaps that I noted in the last chapter, which remain significant in the Chinese economy. In addition, there is no confidence that this policy will remain in the near future. With President Xi's anti-corruption campaign underway, there has also been a consolidation of government. If the consolidation continues and the government keeps searching to crack down on corruption, it may be unlikely that the central government is willing to give more freedom to local governments, especially when it comes to their funding. So, similar to the balancing between consumption and investment, while China has made some progress on creating more balanced growth by allocating more resources to local governments and reducing the influence that the central government has over spending demands, there is still work to be done in this area. Because there have been no signs of creating a formal policy for fiscal decentralization, along with the fact that President Xi has made it a primary goal of his administration to crack down on corruption, I argue again here that the likelihood that this change occurs is rather slim, which would lead the continued growth in these provincial gaps. A more effective policy of fiscal decentralization, consisting of more allocation of resources to local governments and a transferring of more fiscal authority to local governments, would create more of an impact as it would give these local governments the ability to solve problems that are specific to certain regions of the country.

Financial Market Reforms

The final economic reform that is crucial to the continued growth of China is the liberalization of financial markets through the reduction of government presence in the economy and the development of institutions to foster private capital accumulation. From my analysis in the last chapter, I found that during the first two stages of development, the Chinese government was playing too large a role in the economy, causing China to suffer from the known problems of State Capitalism with the mismanagement of SOEs and the inefficient implementation of the state capitalist structure. While I also found that the government was gradually reducing its presence in the economy during the last stage of development, this trend must continue as China prepares for an even more liberal model of State Capitalism. In addition, to cope with the increased globalized nature of the economy, independent economic institutions are needed to compliment those that China has gained access to when it joined the WTO in 2001. All of this is to foster private capital accumulation and increase the role of the private sector to create more sustainable growth as China moves forward. Similar to the measurements I used for other economic reforms, here I am looking for an overall trend that points to China's ability to continue to institute these reforms as it moves to the minority investor model. I should find that China has continued to reduce the involvement of SOEs in the economy while creating more institutions to monitor markets. I should also find that private capital accumulation has increased, measured by levels of household consumption relative to government consumption. In this section I argue that while China has continued to reduce the presence of SOEs, leading to a light increase in household consumption relative to government consumption, there has been almost no movement to create more institutions to monitor financial markets. Furthermore, while there has been an increase in household consumption, the economy is still too reliant on government spending, making economic growth still too dependent on the government.

While there has not been a significant rise in consumption and income nor the creation of institutions that are needed to foster private sector development, the trend of reduction in government presence in SOEs and the privatization of more firms creates an optimistic outlook for Chinese financial markets. From my analysis in the last chapter, there was a significant decline in the number of SOEs reported by the Chinese government as more firms were becoming privatized. In 2016, the Chinese economy had 40% fewer SOEs than it did at the height of its growth, with most of the privatization occurring in the early 2000s. In addition, household consumption was up an average of 12.1% per year from 2008 to 2016 and incomes in both rural and urban areas were up as well. So the overall trend for the majority investor model is that there has been a significant decline in government presence in the economy, with the government reverting to a supportive role of SOEs. This, I argue, is the only sufficient reform that China has implemented in this sector. Should this trend continue, then I predict that the government's involvement in the economy will be sufficient for it to transition to the minority investor model. With a higher number of privatized SOEs and a government that takes a supportive role in the economy instead of instituting direct control over firms, the Chinese economy will be well prepared to face more globalization and higher competition from foreign companies.

However, that is the extent to which the Chinese economy has instituted financial market reforms. While household consumption is up an average of 12.1% per year, that is actually lower than the growth rates in household consumption during the first two stages of development for China. Furthermore, the growth rate of income per capita has been declining for the past 7 years. While this can be partially attributed to the increasing wealth gap, with rural incomes lagging far behind urban incomes, there has also been a decline in urban incomes as well. Urban incomes overall are growing at a 3.5% slower rate than they were under the traditional and majority investor models. In addition, there has been no attempt to create independent institutions to monitor financial markets. So what we are seeing is that even though the government has reduced its position in the economy, the private sector has yet take off completely in its growth. This is likely due to the fact that the growth has been concentrated to the population with connections to SOEs and the rapidly growing economy and has not been extended to the rest of the country. However, despite this lack of development, I still predict that this is where China will be the most successful in its reforms moving forward. The necessary reduction in government presence is already taking place so if that trend continues, private sector growth will follow in the next years. The primary concern is the lack of institutions. Currently, the Chinese government would have to rely on international organizations like the WTO to police international markets but would lack an independent body to monitor markets. While there was the creation of The State-Owned Assets Supervision and Administration Commission of the State Council (SASAC) in 2001, this body focuses primarily on monitoring how to continue its growth rather than serving to police markets. Others have argued that there is a bubble in Chinese investing, so without the proper institutions, this could be the sector that leads to the ultimate burst of the Chinese economy. But there is also the possibility that with the smaller role in the economy, the government can serve as a watchdog. The only reservation with this is that the government would likely be biased, favoring growth over the prosperity of the rest of the country. But even with that risk, if China can start to make more of a move toward creating the proper institutions, I predict that Chinese markets will be well equipped for the minority investor model.

Political Reforms

The final reform that I deem necessary for China to continue its development is for it to liberalize politically so that it may be better prepared to deal with the effects of a more liberal economy. While outside the economic realm, political reform is nonetheless a key point that not only better prepares the government for the minority investor model, but also affects the implementation of the other reforms. A strong central government is an inherent part of State Capitalism. Some have even deemed that an authoritarian government is part of the criteria for the success of the model. And I agree that for the first stages of development using this model, a strong central government, even authoritarian, is necessary in order to take the necessary control over the economy. Looking at what occurred in Brazil under State Capitalism, instituting central control over the economy is nearly impossible in a democratic country as the people who advocate for such a policy tend to be voted out of office. However, I argue that a liberal government becomes more necessary as the economy becomes more open. As the economy becomes more liberal, government inefficiencies begin to outweigh the benefits that come from central economic control, and the freer economic system begins to clash with a restrictive political system. Thus, as China begins to transition to the minority investor model, it must finally address this issue. For measuring the level of reform in this area, I am looking at the Corruptions Perception Index from Transparency International and the Democracy Index from the Economist Intelligence Unit. Similar to the other factors, I am only looking for a trend in this case and not a complete liberalization of the Chinese government. The deciding factor will be if the government can allow the private sector to flourish and if the central government can loosen its control over lower levels of government to allow them to deal with regional issues more effectively.

China has done an effective job of instituting some political reforms and reducing corruption, but its crackdown on political subversion and its strengthening of the rule of law have left the government ill-prepared to deal with a more liberal economy. Under President Xi, there has been a declared policy of reducing corruption in the government, a key factor that led to the downfall of other state capitalist countries. The Chinese government has also focused on reforming state governance and modernization in order to help balance the state and civil society. There has been an increase in the sentiments for the rule of law and local elections have become freer, making the idea of fiscal decentralization more plausible and making local governments more effective in general. For the most part, these policies have been rather effective as China's score on Transparency International's Corruption Perception Index (CPI). Since the start of President Xi's campaign, China's CPI score has increased from 32 to 40, signifying a significant decrease in corruption during this period relative to the rest of China's growth that I have analyzed. In addition, there has been an increase in China's rating in the Democracy Index released by the Economist Intelligence Unit. While still classified as authoritarian, China's rating has been steadily increasing for the past 8 years from 2.97 to 3.14. What these increases show is that the Chinese government is effectively addressing two of the key political issues with state capitalism, the inefficiencies of government and the need for a balance between government and the private sector. As mentioned before, government becomes a hindrance to growth due to its inefficiency. Corruption plays a large factor in this. So with a reduction in corruption, the government becomes more effective in managing economic growth. Furthermore, by reforming state governance, the Chinese government has realized the important role of the private sector and is finding the necessary balance for it to flourish. So as China prepares to adopt the minority investor model, it has effectively reduced government inefficiency and made room for the private sector to keep growing.

However, with the crackdown on political subversion and President Xi's attempts to consolidate more of his power, China is serious lacking in political reform as it moves forward.

China clearly has not liberalized politically but has rather increased the efficiency of government in running the economy. With its crackdown on political dissent and its restrictions on the internet, China has kept the same "Patriotic Education Campaign" as a central pillar of its policies, focusing the people's aggression on foreign threats while promoting nationalist sentiments.[54] In addition, with President Xi's recent movement to consolidate power in his hands and abolish term limits, there has been a strengthening of the central government in addition to the reduction of civil liberties. There is no argument to be made that China has liberalized politically, but because the government has become more efficient, I predict that this level of reform may be enough for China to cope with short-term future growth. There has been a sufficient reduction in government mismanagement and the reform of state governance and the empowerment of local governments makes the outlook on the implementation of the other reforms more optimistic.

But looking past the minority investor model, further liberalization and reform of state governance will be needed. As people become more economically empowered, the necessity for political liberalization becomes more crucial. In dealing with the various infamous incidents of resistance from its citizens, most notably after Tiananmen Square, the Chinese government has successfully managed popular discontent by offering "pain relievers" to address early signs of unrest, including reemployment centers for workers, migration programs aimed at lowering regional disparities, and the "new countryside movement" to improve infrastructure, health care, and education in rural areas.[55] However, "pain relievers" can only do so much without solving the deeper underlying issues with the lack of political freedoms. The empowerment of the people

[54] Aaron L. Friedman. "The Authoritarian Challenge: China, Russia and the Threat to the Liberal International Order," *The Sasakawa Peace Foundation*, August 2017.
[55] Yang Yao, "The End of the Beijing Consensus," *Foreign Affairs*, February 2, 2010, https://www.foreignaffairs.com/articles/china/2010-02-02/end-beijing-consensus.

economically will only serve to make these issues worse for China. The government has stated multiple times that it will not blindly follow western policies, so progress will be hindered in the future. But, as I stated earlier, a complete liberalization is unnecessary. It is likely that corruption continues to fall due to President Xi's campaign and the fact that reducing corruption can occur in an authoritarian government. However, because the Chinese government is so centralized, I predict that the empowerment of local governments and the balance between civil society and the state governance will become more difficult to continue. In addition, it is extremely unlikely that the government loosens its grip on the information getting to its citizens and continues its crackdown on political dissent. Nationalism has and will continue to be a central goal of the Chinese government and any attempt to subvert that will most likely be unsuccessful. Thus, while the Chinese government has effectively implemented some reforms by reducing corruption and improving the fluidity of government, the deciding factor for how its growth will continue into the minority investor model and beyond will be whether the government can continue these reforms when it may be difficult for the central government to give up more power.

What This Means for China's Future:

So in concluding my analysis of China's ability to institute necessary economic and political reforms, the last question to address is: what does all of this mean for the future of China's growth? In short, China has been able to successfully position itself to move forward with some reforms, but with others, China is seriously lacking. With the balance between consumption and investment, the Chinese government has not been able to effectively address domestic consumption and the crowding out of investment by FDI, leaving the economy too dependent on foreign countries. In addition, there has been no improvement in technological development, meaning that the continued high levels of investment are inefficient. In addressing the provincial growth and wealth gaps, while China has given more power to local governments, the plausibility of installing a successful fiscal decentralization program seems unlikely given the current structure of governance. Even with a successful fiscal decentralization policy, the provincial growth and wealth gaps are so massive that it would take a significant period to rebalance. China has perhaps been the most successful in liberalizing financial markets, allowing the private sector to develop and flourish. Finally, with political reforms, while China has sufficiently dealt with government inefficiency and corruption, its lack of political liberalization will become a hindrance as the economy becomes more liberal as well.

Thus, with China being able to implement some reforms effectively, some poorly, and others conditionally, the results are mixed. What this leaves is two plausible scenarios in my view. The first is China reverts back to its model of a dominant central government exerting control over the economy such as in the first two stages of its development. In this case, China will suffer from the same problems that have plagued every other state capitalist country. Because of government inefficiencies and the misalignment of objectives, the economy will begin to slow due to the ineffectiveness of the model. Scenario two is China continues down this path of development, continuing to liberalize and globalize its economy while reducing the role of government. In this scenario, I believe that the lack of implementing these reforms will not have an immediate effect on China's growth. Given the unmatched levels of growth that China has posted, combined with the massive accumulation of wealth and the subsequent international power that has come with China's growth, its economy will not be declining anytime soon. China will continue to grow and exercise its immense soft power capabilities, competing with the United States for global hegemony. However, the lack of reform will begin to catch up with

China. As it prepares to become even more liberal and transition to the minority investor model, the gaps in its growth will become more apparent and more critical. Thus, while short term China will continue its success and grow as a global superpower, long term China will have a critical slowdown unless it begins to institute these changes. Whichever scenario China chooses is a product of the next years economically and politically.

Chapter 7

Conclusion: The End of the Free Market?

In conclusion, I now extend the results of my case study on China to State Capitalism as a whole. I will be analyzing what my results mean for State Capitalism as an economic model as well as what it means for governments, for developing countries, and for free markets. Generally, I argue that China really has not developed a new economic model, as others have argued. But rather what we are seeing is a more nuanced form that develops from the base state capitalist model. However, there is a role for State Capitalism in economic growth, specifically in the early stages of development when firms cannot compete internationally with larger free-market companies. But while China had specific issues that it needed to reform, these problems will be different between various future cases. Thus, while State Capitalism can be an effective growth model for developing countries, the success of the model depends on a countries' ability to adapt to their unique economic issues. During the later stages of development, models will be more nuanced, with the government maintaining a more active role in some cases and retreating in others. Looking forward, the likelihood that state capitalist countries coexist in the international system with free markets is high, so free markets must take a more diplomatic position in incorporating different economic models into the existing order. In order to avoid a post-modern world where developing countries are closing themselves off to globalization, free-market economies need to welcome developing countries into the international system to foster their growth, forcing these countries to adopt more liberal economic policies.

From the results of my case study, I find that China really has not developed a new economic model but instead has made its own version of State Capitalism built on a similar base model to other cases. Contrary to a lot of the other arguments being made on China's economic development, their early growth model was characterized by the same tactics that other countries used to spur their growth, namely the targeting of specific industries and government intervention in those industries with preferential treatment of SOEs. But as China switched to the majority investor model, small nuances began to permeate the model, which caused it to seem as though they had developed using a completely different model. But in reality, they have just used the same model adapted to their unique problems. What China's growth shows is that it used the same base state capitalist model that we have seen in many other cases including the Asian Tigers, Russia, and Brazil. But in order to deal with the specific issues that arose during the first stages of development, China developed its own, more nuanced version of the model. This is where I think Dani Rodrik's theory comes into play, where countries begin developing models specific to the way in which their economies are running. During development, there arrives a crucial point where reform is needed and countries begin to adopt their own more nuanced economic models. China is not an exception as it used the traditional model during the early stages of development and ended with a model that combines both free market and state capitalist policies.

So what this means is that State Capitalism is a viable alternative to free market policies for economic development, but with some significant conditions. Given the current nature of the international economic system, firms in developing countries are unable to compete globally at first, which stalls growth and leaves countries behind. So State Capitalism can serve as an effective means of protecting these industries and allowing them to grow large enough to compete internationally. But after a certain point, the traditional model of State Capitalism becomes ineffective and more liberal models are needed in order for a country to continue its growth. The success of the model then depends on certain conditions, which are large enough to warrant caution for countries looking to adopt this model. First, the model is dependent on a government's ability to extend control over the economy. This is only a likely scenario for more right-wing governments that already have significant control over the country as a whole. I believe that it is unlikely we see a successful case of State Capitalism in a democratic country due to the unpopularity of instituting government control over the economy. Such an effort in a democratic country would likely lead voters to remove those from office pushing for such policies. In addition, as we have seen from the case study, the success of the model is also dependent on a country's ability to adapt to the various problems that arise during development. A lot of this reform comes from the liberalization of government too, which is an unlikely scenario given the need for authoritarian control during the earlier stages of development. Is the success of State Capitalism in its ability to position countries to make these reforms more easily than in free markets? It is difficult to say now. The case of China could be a success story because of better governance or could be representative of a more effective economic model. Only with more cases can a more complete decision be made.

With these significant conditions being vital to the success of the model, I predict that it is unlikely that we see a fully developed state capitalist country continue using the model well into its growth. It is likely that developing countries adopt state capitalist policies during the early stages of their growth. As we have seen from this case study, and from other cases a mentioned before, State Capitalism has been an effective model in spurring growth. With government providing concentrated development in key industries and giving firms preferential treatment, State Capitalism has been better able to position firms to compete internationally than free markets. Given the success of the model in these cases, other developing countries will adopt this model to allow them to compete on a global scale. But with the need to create all of these difficult and unlikely changes, countries will start to move away from State Capitalism and adopt more nuanced models based on their developmental stages as China did. Thus, the later stages of economic development will be characterized by varying economic models, where the government maintains a dominant role in some cases and retreats more in others. Nevertheless, developing countries will likely have models that combine both state capitalist and free market aspects, with the degree of each being determined by the nature of their growth.

So with the success of the model in the early stages of development but the need to reform later, what does this mean for governments? For democratic governments, I think that while it is possible for them to use is this model, it is rather unlikely given the political consequences that come with increasing the role of the state in the economy. There are methods that democratic governments could use to protect industries and create growth that are similar to state capitalist policies. With the use of tariffs, subsidies, research and development programs, and infrastructure initiatives, governments could boost development by targeting specific industries for growth while maintaining technological efficiency. However, while there is a benefit in using these protectionist policies, a higher level of government control over the economy is needed in order to create the success that other state capitalist countries have seen. And because of political consequences, their effectiveness will be limited. As we have seen in India and in Brazil when they tried to implement state capitalism, the unpopularity of the government controlling the economy caused the model to fail. While it would be easier to implement needed reforms with a democratic government, it would also be nearly impossible to institute these economic policies in the first place. Thus, the remaining solution would be to join the economic system earlier and use the same free market policies that have characterized the rise of the current economic system. Democratic governments could resort to old methods to protect certain industries, but their economic success is extremely dependent on how they fare in the international system. But for more right-wing governments, this model will likely be the best method for them to increase their international power through economic development. With soft power becoming increasingly important in the world, State Capitalism may be an effective means for countries to increase their regional or global power by increasing their economic capabilities. However, this comes with a large warning due to the need to reform. Because reform is such a crucial part of the model, there is a possibility that the model simply leads to the inevitable economic decline of a country. If an authoritarian government were to implement the model and fail to make the necessary changes after the early stages, then they are just growing into a wall of issues that would eventually lead to economic failure. So while it remains as a useful tool for right-wing governments to increase their soft power through economic growth, the model needs to be implemented correctly to avoid the inevitable economic collapse that would come with the failure to implement needed reforms that arise during development.

Finally, with the likelihood that we see this model used again among developing countries, and with the continuing rise of countries that have already adopted the model, what should the best response be from free markets? As others have argued, I agree that the best response is continued openness. Free-market economies should continue to welcome developing countries into the international economic system, forcing them to adopt more liberal economic policies. Part of the major issues with State Capitalism is that there is extreme difficulty for right-wing governments in implementing the necessary reforms when moving to a more liberal economic model. By being more open to developing economies in the international system, free markets are forcing the hand of state capitalist countries and making them either face the need to move to a more liberal model or face economic decline. If countries begin to close off to globalization and adopt more protectionist policies, then the state capitalist model becomes more viable, making it likely that more countries adopt that model and reject free markets. As we have seen with China and the Asian Tigers, it is possible for free market and state capitalist economies to coexist in the international system, so there is no need to reject countries that have chosen a different means of economic growth. The current challenge lies in getting new developing countries to adopt free-market policies when it is more difficult to experience the same levels of growth as state capitalist economies. This will come through the promotion of democracy and liberal values as countries that adopt state capitalist policies tend to reject the majority of other liberal values as well. With state capitalist economies either being forced to adopt free-market policies in the later stages of development or face economic decline, free-market policies still remain the dominant way of creating long-term economic growth, so there is no need for drastic action on the part of western economies. By simply promoting democratic values and maintaining an open international economic system, free-market economies can make State Capitalism a path for developing countries to join the economic order, where they will then adapt to the free market and adopt more liberal economic policies.

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